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The Indonesian Quarterly

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- Indonesia: A "Broken-Backed" State?

REVIEW OF ECONOMIC DEVELOPMENT

- Indonesia, Sinking at a Standstill

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- Political Islam and the Use of Societal Approach in Indonesia's Foreign Policy
- Some Determinants of the Female and Male Labour Force's Participation in Indonesia
- Economic Aspects of Energy Resources and Its Implication for Sustainable Development
- Effects of the Increasing Regionalization on the Internationally Diversified European Companies

CENTRE FOR STRAT AND INTERNATIONA STUDIES

The Quarterly

The Indonesian Quarterly is a journal of policy oriented studies published by the Centre for Strategic and International Studies (CSIS), Jalan Tanah Abang III/23-27, Jakarta 10160. It is a medium for research findings, evaluations and views of scholars, statesmen and thinkers on the Indonesian situation and its problems. It is also a medium for Indonesian views on regional and global problems. The opinions expressed in *The Indonesian Quarterly* are those of their authors and do not necessarily reflect the opinion of the CSIS.

The Logo



To better represent the underlying ideas that gave birth to the CSIS in 1971 the Centre uses as of 1989 the logo that figures on the front cover of this journal. The original, in bronze, designed by G. Sidharta, it consists of a disc with an engraving that depicts the globe which serves as a background to a naked man with an open book laid on a cloth over his lap, his left hand pointing into the book, his right hand raised upwards. Altogether it simbolises the Centre's nature as an institution where people think, learn and communicate their knowledge to whoever are interested, to share it with them, mankind the world over being their concern and the globe their horizon. The nakedness symbolises the open-mindedness, the absence of prejudice, in the attitude of the scholars who work with the Centre, just as it is with scholars everywhere. The inscription reads *"Nalar Ajar Terusan Budi"*, which in the Javanese language essentially means that to think and to share knowledge are only the natural consequence of an enlightened mind. It is a *surya sengkala*, that is *chandra sengkala*, a Javanese traditional way to symbolise a commemorable year in the lunar calendar, adapted to the solar calendar system. It consists in using words that express the perceived meaning of the commemorated year while marking the year at the same time, each word having a numerical value. Thus, the inscription, in reverse order, represents the year the CSIS was established: 1971.

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ABSTRACTS

SOME DETERMINANTS OF THE FEMALE AND MALE LABOUR FORCE'S PARTICIPATION IN INDONESIA

By **Tubagus Feridhanusetyawan, Haryo Aswicahyono and Ari A. Perdana**

This study analyzes the determinants of female and male labor force participation (LFP) rates in Indonesia during the period of economic liberalization and rapid growth (1986-1997). First, the study estimates the determinants of female and male labor force participation by using the Probit model. Using a gender-based decomposition analysis, the study attempts to explain whether the female-male LFP gap is due to lower productivity-related endowments of female labor or the existence of structural barriers —including possible discrimination— for women to enter the labor market. The findings suggest that due to the lower structural barriers, the female-male LFP gap in the urban areas has been narrowing slightly during 1986-1997. Yet, the difference in endowments of female and male labor becomes even larger. However, the rural LFP gap is widening, as the difference in endowments increases.

ECONOMIC ASPECTS OF ENERGY RESOURCES AND ITS IMPLICATION FOR SUSTAINABLE DEVELOPMENT

By **Armida S. Alisjahbana**

This article discusses salient economic aspects of energy resources in Indonesia and its implication for sustainable development by highlighting the supply aspects of energy resources, most notably those of oil, gas and coal. The discussion will also cover recent trend in energy consumption, its role in the economy, and immediale challenges as well as some possible problems.

POLITICAL ISLAM AND THE USE OF SOCIETAL APPROACH IN INDONESIA'S FOREIGN POLICY

By **Anak Agung Banyu Perwita**

This article delineates the competing alternative approaches in foreign policy and the need of involving a larger public participation in Indonesia's foreign policy. It takes the revival of political Islam in Indonesia as a case study of a growing demand of the public involvement in Indonesia's foreign policy. The article agues that the massive reactions of some elements of Indonesia's Muslim society toward the war in Afghanistan and the wave of anti US mass demonstration were a clear examples of strong willingness of domestic participation in Indonesia's foreign policy.

EFFECTS ON THE INCREASING REGIONALIZATION ON THE INTERNATIONALLY DIVERSIFIED EUROPEAN COMPANIES

By **Heike Proff**

This article discusses the effects of regional integrations in Southeast Asia as well as in North and South America on the environment of internationally diversified European companies. It also discusses the problems as well as the opportunities generated by the regionalization. The article is based on macroeconomic analyses of the effects of regionalization and hypotheses of strategic management regarding the development of opportunities and constraints. Starting points at the business unit level are possibilities for dissociating cost and benefit increases along the value chain and on the corporate level advantages of multiple-point competition, i.e., decreasing market risk and rising returns. Regionalizations increase the pressure to be innovative as an entrepreneur. This pressure can be met at the business unit level only by hybrid strategies ("dual business"). At the corporate level, the advantages of multiple-point competition must be exploited with the help of diversification and concentration strategies.

ASEAN After Brunei Summit: Re-inventing Regional Commitments?

Landry Haryo Subianto

INTRODUCTION

THE Association of Southeast Asian Nations (ASEAN) had just recently successfully completed two of its important events, which were the 7th ASEAN Summit, and the subsequent 5th ASEAN+3 Summit. In addition to that, ASEAN also held the 3rd ASEAN+1 Summit, in which ASEAN leaders met with the leaders of China, Japan, and Korea separately, and discussed substantial matters existing between ASEAN and each of these respective countries. All summits were held in Bandar Seri Begawan, the capital of oil-rich Brunei Darussalam from 5-6 November 2001.

Like any previous ASEAN meetings and summits, especially in the light of regional economic recovery and engulfed by the spirit of co-operation between the Southeast and Northeast Asia, the main agenda and topic discussed during the Summits were on the strengthening of economic co-operation between the two sub-regions. Issue of regional integration was also raised with special reference to the common endeavors to promote regional co-operation and mechanism, i.e., administering regional and sectoral development projects, enhancing security dialogue and political co-operation, and the strengthening and establishment of ASEAN and/or ASEAN+3 Secretariats. Aside from political and economic talks, leaders from both sides also discussed critical social issues such as HIV/AIDS, cultural and information exchange, including the undertakings to limit the development and digital gaps in Southeast Asia.

Amid numerous agreements reached during the Summits -mostly related with the strengthening of ASEAN internal and external co-operation and development- there are in particular two important outcomes that may substantially affect the overall relations within ASEAN and the Association's external relations, especially with other

dialogue partners. *First*, on security-political matters, ASEAN leaders agree to issue the 2001 ASEAN Declaration on Joint Action to Counter Terrorism, through which leaders of ASEAN reiterate their firm commitment to "countering, preventing and suppressing all terrorist acts in accordance with the Charter of the United Nations, especially taking into account all relevant UN resolutions."[1] *Second*, acknowledging the economic importance of China, especially after China's entry into the World Trade Organization (WTO), ASEAN leaders endorsed the proposal for a Framework of Economic Co-operation and to establish an ASEAN-China Free Trade Area within 10 years.

The two points above are important for at least three main reasons: (1) a possibly new setting of world politics after the terrorist's attacks on 11 September 2001 in the U.S.; (2) The nature of regional politics and economic dynamism in East Asia, in which China is believed to be the core determinant factor, along with Japan; and, (3) Efforts of ASEAN to retain its importance in regional politics by critically evaluating its overall policies and mechanisms. Accordingly, the discussion in this article is focused on the relationship between two important outcomes of the last ASEAN Summits and those three important considerations.

[1]See the Press Statement by Chairman of the 7th ASEAN Summit and the 5th ASEAN+3 Summit in Brunei Darussalam, issued on 5 November 2001, as can be seen at the Official Web Site of ASEAN Secretariat, http://www.aseansec.org/menu_7thsummit.htm, accessed on Thursday, 6 December 2001 (12:01).

ASEAN AND TERRORISM: A NEW COLLECTIVE EXERCISE?

A series of terrorists' attacks on 11 September 2001 at two American military and economic symbols had really brought back a rather neglected discourse in international relations, which is the act of terrorism mostly committed by non-state violent actors (individual or groups of individuals). Such a horrendous terror served as a strong reminder that even as the sole superpower in the world, the U.S. cannot prevent the attacks by a group of individuals with multi-national identities.

Tragedies at the World Trade Centre, New York, and the very heart of U.S. defence establishment, Pentagon, did pose a serious challenge, not only to the way countries or government protect the national stability and security of its people and territory, but also to the conduct of post-Cold War international relations. During the Cold War, world politics was defined by competing ideological and political alignment followed by massive power build-ups. The world was then simply divided as the Communist (East), and Capitalist (Western) blocs, or neutral (non-aligned). All countries without exception were divided into these categories.

The collapse of Communist bloc marked a new configuration of post-Cold War era. Following the triumph of Western bloc, the ideas of democracy and liberal-capitalism were two immediate features coming out as the Cold War ended. The intensified proliferation of these ideas can be seen in many countries.

Security implication of such a dramatic changing situation is that countries are no longer preoccupied by hardcore conventional security threats, such as the possibility of inter-state wars. Rather, governments in many parts of the World are now mostly faced with non-conventional threats, which heavily involve non-state actors, and non-military related issues. Responding to this challenge, new initiatives and paradigms were then formulated accordingly. Packed in the concepts of comprehensive, co-operative, and human security, discourse on security is renewed by putting more emphasis on the security of individuals, and community as the basis for overall state security assessment. Environment, illicit drugs, human and (small) arms trafficking, as well as piracy and terrorism are some of eminent subjects debated by a wider security concerned community (military, police, civilian bureaucracy, and epistemic community).

However, beyond rhetoric, many governments do not immediately subscribe themselves to such a new security trend and paradigm. Apart from semantic problems found in defining new security concepts, one of the most illuminating arguments is the compatibility issue between the so-called human, co-operative, and comprehensive security concepts and the generally accepted concept of state sovereignty. Many countries, including ASEAN countries, still question the degree of co-operation a state is so willing to achieve with others that it does not negatively affect their self-assumed sovereignty. They simply juxtaposed these new concepts with the idea of intervention as can be found in the case of humanitarian intervention. In short, what kind of measures of co-operation states have to formulate, and compel with in order to avoid the misperception that may lead to a worse situation, and what constitutes domestic and common problems are some of basic questions ASEAN needs to address immediately.

Within the context of ASEAN, such a debate has prevailed for at least the last few years, and eventually gained its momentum when the economic crisis hit the region. As ASEAN was originally established and developed as a regional vehicle to prevent an inter-state conflicts, and thus, heavily centralized on the primacy of state and its attributes (including sovereignty), recent regional and global shocks caused mostly by non-state economic actors (e.g., speculative fund-managers) had brought about new consciousness that ASEAN or any other state-based organizations is yet prepared to meet challenges posed by a non-state actor. Indeed, another part of story from recent crises also encompasses states' inadequate capacity and lack of capability in conducting the so-called democratic and good governance, which contribute significantly to the worsening ramifications. But the core argument here is that these numerous state-base regional organizations cannot anticipate challenges or even threats at a large scale posed by individuals or groups of individuals precisely because, due to various reasons, mostly related with the issue of non-interference and state's ultimate sovereignty, it is not designed to perform such a task. It is only recently that the issue is seriously discussed, which then becomes a mainstream policy guideline.

Indeed, this is not to say that ASEAN, or any other regional organization in a wider region of Asia Pacific, is a failure. Instead, it serves as a reminder that the circle of institutional mechanisms within this respectful organization is yet to be completed. To be successful, ASEAN needs to reconsider its policy from the top, which seems far from sufficient. In this case, ASEAN should seriously take into account the societal management at the micro level.

As a matter of fact, non-state actors are relatively mobile and generally move faster than state. They can easily jump over the official and diplomatic procedures, and therefore becoming a trans-national actor in its very real term. Organized crimes' activities are some of the examples to that point. The other would be the terrorist movements, insurgent actors, and so forth, that can move from one jurisdiction or territory to the other, and thus creating serious bilateral problems. This can pose serious dilemma for an organization like ASEAN, where diplomatic appropriateness is one of the most fundamental tenets. The speed of response mechanism will always be behind the real time situation on the ground.

In order to resolve the problems, ASEAN does and will have to open up a wider window of opportunity for maneuvering at practical level. This can be undertaken only if ASEAN can agree on some basic arrangement and measures. A Joint surveillance and multilateral or bilateral legal arrangements (extradition) are two important actions, but further political arrangements should be readily made available to ensure that any forms of disturbances to security can be promptly met and tackled.

Nowadays, as an immediate implication of recent terrorists' attacks, the World is now witnessing a more or less similar situation as that of the Cold War, albeit different set of contents.. In the past, as mentioned earlier, the World is simply divided as the East and West, and neutral in between, with the conventional security measures served as defining line. Now, the World is again potentially divided into such a categorization. The U.S. President, George W. Bush, Jr., has given a clear and strong warning "either with us or against us", with no other alternative options.

Immediate needs to build a solid international coalition against terrorism are then aired through all political and diplomatic channels known to contemporary international relations, especially through the U.N., regional organizations, media and so forth. This had provided little room for many countries to position themselves in the World political current, especially for Moslem countries whose governments are challenged by domestic stability, and suffered from achieving domestic political consensus towards the issue. Although in principle, these countries would be willing to comply with international desire to fight against terrorist, hence, much of their hesitation rests in the fact that there is no clear definition of the act of terrorism.

Furthermore, there are yet measures as to what extent do countries, or a coalition should act and respond. Are military intervention and attack, as shown in Afghanistan,

the only means to fight terrorist groups? Naturally, all violent groups will set their bases in one or more countries. The hypothetical question is then what if one of these groups resides in one of ASEAN countries, which government lacks the ability to deal with them? How consensus to allow external intervention can be reached accordingly? What if the respective government objects to the external intervention? Would it also be seen as protecting the terrorists while in fact they are also fighting in their way?

The above legal and moral dilemmas are precisely parallel with the ongoing debate within the Association, reconciling acceptable degree of "external intervention" by a single or multi-countries to address issues of common concerned. When it comes to issues on environment, illegal fishing and trafficking or even piracy, joint actions can be undertaken, albeit in a very limited manner. However, how ASEAN, as a collective institution, could and should address the act of terrorism such as kidnappings committed by certain radical groups of insurgencies is far from clarity.

Needless to say, leaders of ASEAN are fully aware of the critical importance and urgency to act concertedly against terrorism. As reflected in the 2001 ASEAN Declaration on Joint Action to Counter Terrorism, they clearly understood that in case this region has been known to host local, regional and international terrorist networks, closer co-operation at all levels and branches of government is needed accordingly. However, ASEAN must also realize that its endeavors to fight terrorism as envisaged in the Declaration will face serious hurdles stemming from the juxtaposition of terrorism with freedom fighters in several of its key member countries. There should be a common platform, agreed at least among the members, that clearly delineates the so-called act of terrorism and act of freedom fighters, and how different counter measures should be implemented to treat those two type of actions. This is not an easy task to do but it will serve as a better foundation for common understanding among members of ASEAN.

Moreover, governments must firmly communicate and widely socialize its vision of anti-terrorism. They also need to educate the public that terrorism is not an inherent attribute of certain religion (i.e., Islam) and that the act of anti-terrorism is not an act aimed at fighting the devoted Muslims. Instead, it is an act to counter, or even to end a series of inhuman actions committed by those who try to destabilize the social, economic and political life of a nation in the name of religion or any other forms of violent fanaticism. Failure to do so will implicate a serious domestic problem especially in countries where interfaith harmony is currently disturbed.

In turn, to begin its efforts in fighting terrorism, ASEAN must be able to put its members' respective house in order, and strengthening its voluntary self-surveillance mechanism over terrorism and trans-national organized crimes in general. Subsequently, ASEAN should readily prepare itself to extend an anti-terrorist collaboration with a wider community, because as frequently expressed, fighting terrorism will need more than just rhetoric or single voluntary act. Instead, it will require a strong multilateral

commitment and co-ordinated concerted acts of various concerned countries and organizations.

ASEAN-CHINA: STRIKING A STRATEGIC BALANCE THROUGH ECONOMIC MEANS

Another issue that may affect the dynamics of ASEAN in the foreseeable future is endorsement of the proposal for a Framework of Economic Co-operation and to establish an ASEAN-China Free Trade Area within 10 years. Indeed, such a proposal is of strategic importance for both China and ASEAN for numerous economic and non-economic reasons. Economically, China is said to be the next economic giant because of its huge economic potentials. With population of approximately 1.2 billion people, China is claimed to be the largest market of a single economy.

Nevertheless, what makes the idea to have ASEAN-China Free Trade Area critical is due to several reasons. *First*, it will help solving the contending perception that ASEAN and China are in a competing situation, especially after the economic crisis in 1997 in which China is seen to be more attractive as a destination for investments. *Second*, it provides a wider window of opportunity for ASEAN to engage China more directly other than using multilateral political or economic fora. *Third*, it reflects the fact that ASEAN values China in a special way, because (1) it is quite unprecedented to have a free trade area between a state and a regional organization such as ASEAN, and (2) if measured by the economic importance per se, Japan is by all means the most important economic player in the region at least for the time being, and Japan has been the closest economic partner of many ASEAN countries, and yet, neither Japan nor ASEAN is capable of materializing the idea of free trade arrangement between ASEAN as an entity and Japan.[2] *Fourth*, such an arrangement will tremendously affect the overall relations in ASEAN-China relations and in Northeast and Southeast Asia in positive and negative terms.

According to the report of ASEAN-China Expert Group on Economic Co-operation (October 2001), China's real GDP growth during the last decade had averaged 10.1%, the fastest rate of real GDP growth in the world. During the same period, China's exports grew threefold from US$62.1 billion in 1990 to US$249.2 billion in 2000, making China the seventh largest exporter in the world. Besides, FDI inflows into China had grown more than tenfold from US$3.5 billion in 1990 (about 10% of all FDI flows to developing countries) to US$40.77 billion in 2000 (17% of all FDI flows to developing countries).[3]

In addition, the opening up of China's economy through its membership in the World Trade Organization (WTO), the financial crisis of 1997, and growing economic

[2]As a matter of fact, Japan and Singapore agreed to establish a free trade arrangement between the two countries, but due to domestic political and economic considerations, such an arrangement cannot be widened to include all ASEAN-10, in the framework of ASEAN-Japan economic relations.

[3]See "Forging Closer ASEAN-China Economic Relations in the Twenty First Century", a report submitted by the ASEAN-China Expert Group on Economic Co-operation, October 2001, 4.

interdependence between ASEAN and China are some of the arguments that impell ASEAN-China to improve their overall economic relations. The Expert Group noted that foreign trade is an important driving force for the economic development of China and ASEAN. In the 1990s, both China and ASEAN achieved high growth rates in foreign trade. During the decade from 1991 to 2000, China's foreign trade grew at an average annual rate of 15%. In 2000, China's exports amounted to US$249.2 billion and its imports totaled US$225.1 billion. During the period from 1993 to 2000, ASEAN's foreign trade grew at an average annual rate of 10.9%, although the rate was lowered during the financial crisis.[4] It is reported that in 2000, ASEAN-China trade totaled US$39.5 billion growing by an average of 20.4% annually since 1991 when overall trade amounted to only US $7.9 billion. China's exports to ASEAN grew from US$4.1 billion in 1991 to US$ 17.3 billion in 2000 while its imports from ASEAN grew from US$3.8 billion in 1991 to US$22.2 in 2000.[5]

On investment, as indicated by the Expert Group in their report, both China and ASEAN are major destinations for Foreign Direct Investment (FDI) rather than investors in each other's economy. Chinese investments in ASEAN amounted to only US $135.8 million in 1999, representing less than 1% of all FDI flows to ASEAN.[6]

Based on the above description, a study undertaken by the Expert Group strongly suggests that the establishment of a free trade area (FTA) between ASEAN and China will create an economic region with 1.7 billion consumers, regional GDP of about US$2 trillion and total trade estimated at US$1.23 trillion. The magnitude and size of its population, the GDP, and trade among them will make it the biggest FTA in the world.[7] Moreover, the removal of trade barriers between ASEAN and China, as suggested, will lower costs, increase intra-regional trade, and increase economic efficiency. The FTA will lead to greater specialization in production based on comparative advantage. Trade creation occurs when some domestic production in one FTA member is replaced by lower-cost imports from another member. This will boost real income in both regions as resources flow to sectors where they can be more efficiently and productively utilized.[8] The Expert Group also estimates that an ASEAN-China FTA will increase ASEAN's exports to China by 48% and China's exports to ASEAN by 55.1%. The FTA increases ASEAN's GDP by 0.9% or by US$5.4 billion while China's real GDP expands by 0.3% or by US$2.2 billion in absolute terms.[9] Such an initiative to have an ASEAN-China Free Trade Area within the next ten years seems most likely to pose a significant impact on other non-economic sectors.

In fact, for many years China and ASEAN economies are believed to have

[4]Ibid, 7.
[5]Ibid, 12.
[6]Ibid
[7]Ibid, 30.
[8]Ibid, 31.
[9]Ibid

been competing with each other because of their geographic proximity, economic structure and so forth. Besides, there has been a general anxiety among ASEAN economies that China will become powerful competitor economically, especially because of its industrial and manufacturing competitiveness as well as its ability to attract foreign investment. Nevertheless, the success of ASEAN and other East Asian economies during the 1970s and 1980s are also believed to be a result of four combined factors - strong authoritarian regime that ensures the provision of security; the continuous role of Japanese capital; the role of overseas Chinese enterprises; and, China's retraction for the last forty years or so. Thus, when China moves outward, there emerges a perception that China is becoming a major hindrance towards ASEAN's effort to bounce its economy back.

Indeed, as numerous scholarly writings would suggest, how ASEAN or any other countries can deal with a large powerful state, such as China, will remain a question and debatable. Henceforth, in his writing, under the wider rubric of how state responses to rising power, Randall L. Schweller (1999) tacitly argues that state responses can be grouped into six basic policy options: (1) preventive war; (2) balancing/containment; (3) bandwagoning; (4) binding; (5) engagement; (6) distancing/backpassing.[10]

[10]Details of this categorization can be found in Randall L. Schweller, "Managing the Rise of Great Powers," in Alastair Iain Johnston & Robert S. Ross, eds., *Engaging China: The Management of an Emerging Power* (London: Routledge, 1999), 1-31.

As policy choice is largely determined by subjective and objective circumstances, yet, many also believed that ASEAN and any other Asian countries should engage China in a positive way. By engagement, it refers to the use of non-coercive means to ameliorate the non-status quo elements of a rising major power's behaviour. The goal is definitely to ensure that this growing power is used in ways that are consistent with peaceful change in regional and global order.

At this point, ASEAN and other concerned countries have been trying to engage Beijing delicately in a positive way. On the one hand, ASEAN and these countries strongly believe that with the political and economic might China has nowadays, the country is "destined" to regain its rightful position as the region's great power as it had in the past. Therefore, engaging China becomes critical in ensuring that China's ascendancy, as a great power will be positive for the region. Yet, on the other hand, it is not an exaggeration to claim that the high degree of uncertainty in China's behavior, especially in security-political issues is still posed serious concern among ASEAN and countries in Asia Pacific.

The delicate balance should therefore be formulated in such a way to avoid Chinese impression that ASEAN and other countries are ganging-ups against Beijing. One of the alternatives is to attract China into regional multi-lateralism, starting with economic multilateral arrangements such as PECC/APEC and recently WTO, and then moving further to security dialogues, such as the ARF. Hereafter, political tens-

ions that still intermittently exist between China and its Asian neighbors, including with some ASEAN countries confirm the fact that strategic political convenience between China and her neighbours is not yet securely in place.

The above situation has brought about a new awareness that multilateralism is perhaps insufficient in securing relations between China and her neighbors based on mutual confidence. For ASEAN, a bold initiative must be taken to ensure China's commitment towards a condition known in the lexicon of ASEAN-China relations as peaceful co-existence. Along with some purely economic arguments on the virtue of free trade, it is in this very context of political economy that the recent initiative to establish the so-called ASEAN-China Free Trade Area should be understood. Although the initial initiative to institutionalize trade between China and ASEAN was originally proposed by the Chinese side, which was largely inspired and driven by China's strong intention to join WTO, yet this would provide a unique opportunity for ASEAN to engage China economically through a direct channel.

However, such an arrangement will also to some extent affect the overall relations between ASEAN and the rest of Northeast Asian countries, especially Japan. Trade arrangement between ASEAN and China will only pose a negative impression to the Japanese if ASEAN fails to communicate the strategic importance of this new initiative with China. By all accounts, Japan is definitely one of the most important and strategic trade and economic partners for both China and especially ASEAN. Therefore, ASEAN must make sure that such a special trade arrangement with China will not undermine the existing importance of Japan. On the contrary, ASEAN must strongly urge and support the Japanese government in conducting its internal multidimensional reforms in order to make Japan more assertive and creative in proposing new and fresh initiatives complementary to the current nature of ASEAN-Japan economic relations. The last summits held in Brunei seemed to reflect the fact that Beijing, with its relative political and economic advantages and supportive circumstance, is currently more proactive than any other country in Northeast Asia in building closer co-operation with Southeast Asian countries.

CONCLUDING NOTES

After its summit in Brunei, ASEAN is now tasked with two equally important issues, namely dealing with terrorism and finding a delicate balance with regards to the new initiative of establishing ASEAN-China Free Trade Area within the next 10 years as well as its domestic and regional implications.

As mentioned earlier, the threats of terrorism are now becoming more real for ASEAN countries as well as for any other country in the world. Recent tragedy in the U.S. clearly confirms the above assumption. The World is now moving towards a relatively unified response in fighting against terrorism that the act of terrorism cannot by all means be tolerated. ASEAN is no exemption to this trend. Multilateral co-operation at all sectors and levels is one of the most feasible alternatives to such an attempt.

In fact, long before the U.S. tragedy, ASEAN has extensively discussed the issue of terrorism in the context of regional transnational crimes. Apparently, such an endeavor is gaining its momentum now, and needs to be refined both at philosophical and practical levels. At this point, it must be realized that the philosophical questions over the issue of terrorism (e.g., clear definition of terrorism) are not easy to be resolved, especially in the context of Southeast Asia where some of its members are suffering from domestic political upheavals involving numerous groups that can easily be labelled as terrorist especially by the government. Nevertheless, ASEAN must clearly set the measures and agreement on what can be done collectively, how to do that, and the acceptable limit to which the collective attempt to fight terrorism can be collectively undertaken. This will need a much closer dialogue and understanding among ASEAN members, especially on the question of ASEAN principles of non-interference. Whether ASEAN is ready to discuss this matter is of course another issue to be discussed in a frank and open way.

ASEAN's further economic engagement with China as envisaged in the idea of ASEAN-China FTA cannot be taken for granted and detached from other non-economic considerations. ASEAN must carefully assess the impact of such an arrangement both domestically and regionally. Furthermore, ASEAN must once again make sure that this new initiative will not neglect, let alone undermine, the importance of other political and economic partners such as Japan and South Korea. Instead, this should be a catalyst for wider East Asia economic co-operation, as promulgated in the "Joint Statement on East Asian Cooperation" announced by the Leaders in November 1999 in Manila, the Philippines.

Indonesia: A "Broken-Backed" State?

Bantarto Bandoro

TODAY'S Indonesia has been characterized by some unfavorable developments in the form of political upheavals, faltering economy, simmering sectarian conflicts, and ceaseless practice of corruption. Indonesia has seen no respite from such developments since the former President Soeharto was toppled down in March 1998 after 32 years of his autocratic and unchallenged rule. Since then Indonesia has had three consecutive presidents. Soeharto's predecessor, B.J. Habibie, was installed in 1998, but soon was removed in an election in 1999. He was then fol-

*Major portion of this article is taken from author's "Putting Humpty-Dumpty Back Together Again," *The Jakarta Post*, 18 December 2001.

lowed by Abdurrahman Wahid, who stayed in office only for 22 months and was ousted by Parliament in August 2001after a lengthy impeachment process involving charges of corruption. Now Megawati Soekarnoputri heads a fractious and deeply troubled country.

In fact, the instalation of Megawati as the fifth president of Republic of Indonesia was widely greeted with relief by Indonesians who had become estranged by Wahid's erratic and ineffectual leadership. The feared national disintegration of which Wahid had often warned, should he step down, turned out to be non-existent. After his resignation the situation of the whole country more or less remained to be normal and streets demonstration were rarely seen. Nevertheless, Megawati had given little indication of the policy directions her government would take.

Little has been done to fix the economy, while communal conflicts in Maluku, Kalimantan, Poso and instability in Aceh and Irian Jaya countinued unabated. The Government's current decision to increase the price of fuel has greeted with protests throughout the country, thus making the public increasingly lose confidence that Megawati is able to seriously cope with the existing domestic problems. Coruption, lawlessness as well as political scandasl have become and will continue to be the target of public criticisms.

Megawati started her presidency with the announcement of her cabinet's six point working program which includes:

- maintaining national unity;
- continuing reform and democratization;
- normalizing economic life;
- upholding law, restoring security and peace, and eradicating corruption, collusion and nepotism;
- restoring Indonesia's international credibility; and,
- preparing for the 2004 general election.

People expect that such a working program will pave the way for a full restoration of national life. However, facts indicated the reverse. The Government apparently fails to show its strong sense of urgency in dealing with the domestic problems. Due to the Government's lack of capability, Indonesia is at present still facing systemic crises or failures in state capacity and the entire process of governance-a situation which in literature is referred to as a "fractured" or "broken-backed" state, and state "failure" or "collapsed". The argument is both that these failures may curb the ability of the state to respond to people's grievances and to manage conflict, except perhaps through repressive means, and that the effective absense of state control or loss of its monopoly of violance allows societal conflicts to escalate and take violent forms. If such tendency is not responded promply and appropriately, this will in turn foster the "structural violance" of maldevelopment, state repression and intra-elit conflict, which sooner or later give rise to political instability.

The question remains whether Indonesia under Megawati's leadership is heading to the even worsening crisis. The answer is most likely to be "yes" based on the

following indicators: (1) public recognition of the failure of government in development policy; (2) failure in conflict management (as indicated by the escalation of conflict in Aceh, Papua, Maluku, etc); (3) clear signs of defect in democratic process indicated among others by the abuse of state institutions in the promotion of certain political interests. Failure in conflict management is less likely when there is a full functioning of democratic process. People's confidence in Indonesia's fledging democracy is fading away. Other indicators include: the continuation of corruption, collusion and nepotism and failure in the state capacity in upholding basic law and order and security. The overall mood continues to be pessimistic. *The Indonesian Human Development Report 2001* reported that Indonesia has been faced with enormous and diverse challenges-consolidating democracy, addressing regional conflict, and regenerating economy.

Until the end of 2001, Megawati's government has not been able to convince the public that it is on the right track to bring the country out of its deep crisis it has experienced since the late 1998. Although she was at the outset highly praised by the public because she is flanked by strong political and the "economic dream" teams led respectively by Susilo Bambang Yudhoyono and Dorodjatun Kuntjorojakti, thus giving high hopes to the public, the policies they adopted only bred pessimism among the public. The Government's six point working program as stated above provided only the broad guidelines, and the first one hundred days of her office has proven very little.

The confession Megawati made before the annual sesion of MPR (Parliament) that little has been done by the Government to tackle domestic crisis was indeed viewed by some as an honest gesture. But this is not exactly the public wanted to see. In the aftermath of her speech, there was a strong demand from the public that the next two and a half year should be filled in with concrete steps to remedy domestic problems.

There are still concerns, however, that Megawati's government is unwiling to follow the spirit of reform that Indonesia now needs. Instead, her government seems to prefer incremental steps that will certainly do very little to solve domestic problems. The public, therefore, should mobilize whatever resources it has at its disposal to pressure Megawati's government to move very rapidly beyond symbolism to the implementation of clear policies on the economy, politico-security and judicial reform if she is to gain more sympathy from the public.

Perhaps only few Indonesians feel that the performance of Megawati's first one hundred days in office has fulfilled the expectations of the public. No excellent report on the performance of Megawati's government has been widely reported by the media. Sectarian conflicts in Maluku, Kalimantan and other location persist, and there are no signs that conflicts in Aceh and Papua could be permanently halted. The uncertainty in the recovery of national economy, the issue of decentralization, and the lack of willingness to combat corruption, collution and nepotism, to mention a

few, are a clear indicator of the slowness or inability of the government to address the real issues. The crisis faced by Indonesia has united the Muslim leaders to address the moral decadence facing the country and to attribute the crisis to the country's leaders (*The Jakarta Post*, 18 January 2002).

Government's inability to solve the issues will even strengthen the feeling of the public that the present governmet is not very serious in seeking a fresh and effective approach. If such issues continue to exist or become even more complex, or if there are no fundamental changes in the approach to the crisis, then one cannot expect that 2002 will witness significant policy steps. The bomb explosions that have rocked some parts of the country have even strengthened people's perception of the Government's inability to provide security.

There has been already a strong perception that Megawati has never had thorough understanding of the national issues, particularly in terms of economy, and that her past record provides very little indication that she has clear vision and strategy to revive the reform agenda. Her policies during the year 2002, and perhaps beyond, will be tested against the background of such cynicism.

A strong sense of urgency in dealing with current crisis is also manifest in the recent steps initiated by the National Resilience Institute (*Lembaga Ketahanan Nasional*/Lemhanas). In a presentation before the President and her aids, *Lemhanas* proposed eight steps to solve the crisis (*satunet.com*, 23 November 2001). Commenting on the proposals, the President felt the need to have such a program executed by respective ministries. This is, of course, a positive sign which will further stimulate enthusiasm to bring Indonesia out of crisis, and is also in line with the six working programs of Megawati cabinet. Somehow, it is normal to adopt new policies in every crisis condition.

Thus, the Lemhanas initiative can be seen as one that will strengthen Government's efforts to solve the crisis. But the introduction of one new policy after another will be considered valid and applicable only when it is supported by a broad based coalition of public.

The Government should not ignore the possibility that if such policies fail, it is community members, particularly those in the regions, who will suffer the most. This will, in turn, create not only further opposition and dissatisfaction among the pubic and regional factions, but also broaden the arena for conflict among societal groups and even among different factions in the Government.

The worst scenario one would witness is perhaps mass-based insurrection set off by the failure of state to deliver the promised benefits of development or one arising from a growing prominence of ethnic, regional or religious identities. What Megawati's Government must bare in mid now is that its policies for the crisis should be well-formulated and followed up by concrete and realistic steps. Such steps are needed to prevent the contradictions and social tensions already in place within

the society from developing into concentrated and dangerous forms.

Unless the Government is able to restore domestic stability and peace as well as people's confidence, and to resolve protracted regional conflicts without resort to violence, the state of Indonesia will either be collapsed or disintegrated, and it will either be contested or weakened. The daunting challenges of Megawati's government is therefore how to "put Humpty-Dumpty together again" in the form of viable state capable of dragging the country out of its current multidimensional crises.

Public distrust and pessimism will definitely persist throughout the year 2002, even beyond. We shall probably witness even unexpected and dangerous trends in the development of Indonesia, should the Megawati administration fail to show its full commitment to take bold steps in the current crucial issues:

* the eradication of corruption, collusion and nepotism;
* the realization of human rights trial;
* the restoration of economy ;
* the resolution of regional conflicts (in Aceh, Papua and other provinces potentials for disruption); and,
* implementing new approaches to decentralization.

On the Aceh problem, Aceh remains tense as violence continues in some part of the province. The decision of Megawati's cabinet to reinstate the military command in this restive province has only created protests from particular groups of people that it will revive past bitter experience in which the Acehnese were gripped by fears about insecurity for years. The decision indicates that Megawati shares some basic values with the military.

As people's expectations will become higher in the future, Megawati should not make any public speeches that will only create public disilusion that her government is able to carry out every reform program. If Megawati's government fails to uphold the public trust it had enjoyed so far and to implement policies it had promised, the failure will certainly guarantee crisis in other realms or turn the crisis into disaster. The policy question one would ask is: How is it possible to restore the state's capacity -to assure basic law and order, organize development and provide social services and security, etc.- after years of being messed up and neglected?

Indonesia, Sinking at a Standstill

Staff, Department of Economics, CSIS

INTRODUCTION

INDONESIA has effectively tried to continue at a standstill at a time when unfavorable international political and economic situations are bombarding the country. The reform program and actions undertaken was somehow inadequate, and the cracks in the domestic economic landscape can no longer be ignored. This is particularly the case now the world is in economic downturn.

If the government is lucky, the growth rate may reach the targeted of 3.5% by the end of this year. Next year, economic growth could be lower if the government does not introduce widespread reform. Economic growth in 2002 will depend just on the recovery of exports, which in turn depends on the global economic recovery.

In addition to sinking per capita incomes, in a country where the employment growth rate is 2%, these sorts of growth rates cannot service the cost of economic incompetence. The government's enormous domestic debt, about US$70 billion, will start falling due in a couple of years, and the country is in no position to pay for the debt. Instead, interest rates are high yet monetary policy is ineffectual; fiscal policy is narrow and weak; and the banking system is in poor shape and still a drain on the economy.

ECONOMIC GROWTH, WANE SLOWLY

Indonesia's GDP growth (year-on-year) was 3.3%, down from 4.6% in the same period last year. A slowdown in investment was the main cause of slower growth. A more recent deterioration in exports and consumer expectations will put pressure on the fourth quarter growth, and the government will be lucky to achieve targeted growth of 3.5% for the year.

On the expenditures side, the slow down is largely attributable to the sharp drop in investment and a slight decline in exports from 16.7% to 14% (see Table 1). Meanwhile, expenditure on imports increased dramatically over the period, and consumption (both private and government) rose (see Table 2).

Table 1

GDP BY EXPENDITURE
(year-on-year)

	% change		contribution to growth*	
	Q1-Q3 2000 vs Q1-Q3 1999	Q1-Q3 2001 vs Q1-Q3 2000	Q1-Q3 2000 vs Q1-Q3 1999	Q1-Q3 2001 vs Q1-Q3 2000
Private consumption	3.3	5.9	28	93
Government consumption	4.7	7.3	4	12
Gross fixed capital formation	18.7	5.0	44	25
Exports	16.7	14.0	48	83
Imports	9.7	23.1	-24	-112
GDP	**4.6**	**3.3**	**100**	**100**

Source: *Berita Resmi Statistik* No. 33/IV/15 November 2001

Note: *excluding change in stock

The deteriorating world economic climate will further limit the contribution exports make to growth. In the third quarter of this year, import growth, which had been strong in the previous four quarters turned negative. This coincides with the decline in investment and, more specifically, a decline in imported inputs for manufacturing.

The growth rates of the first three quarters of this year mean that the fourth quarter growth rate must be 4.11% or higher for the government to meet its target of 3.5% for the year. Seasonal factors such as Ramadan and Christmas mean that the fourth quarter growth rate is usually higher than the third quarter. But the international and domestic impediments to growth are mounting, and a growth rate of 4.11% may be hard to achieve.

MONETARY DEVELOPMENTS

After increasing rapidly in the first half of the year, the annualised inflation rate has been lingering at around 12-13% since July. Inflation is expected to remain around 13% to the end of the year. And unless Bank Indonesia (BI) keeps the money supply in check and the government improves

Table 2

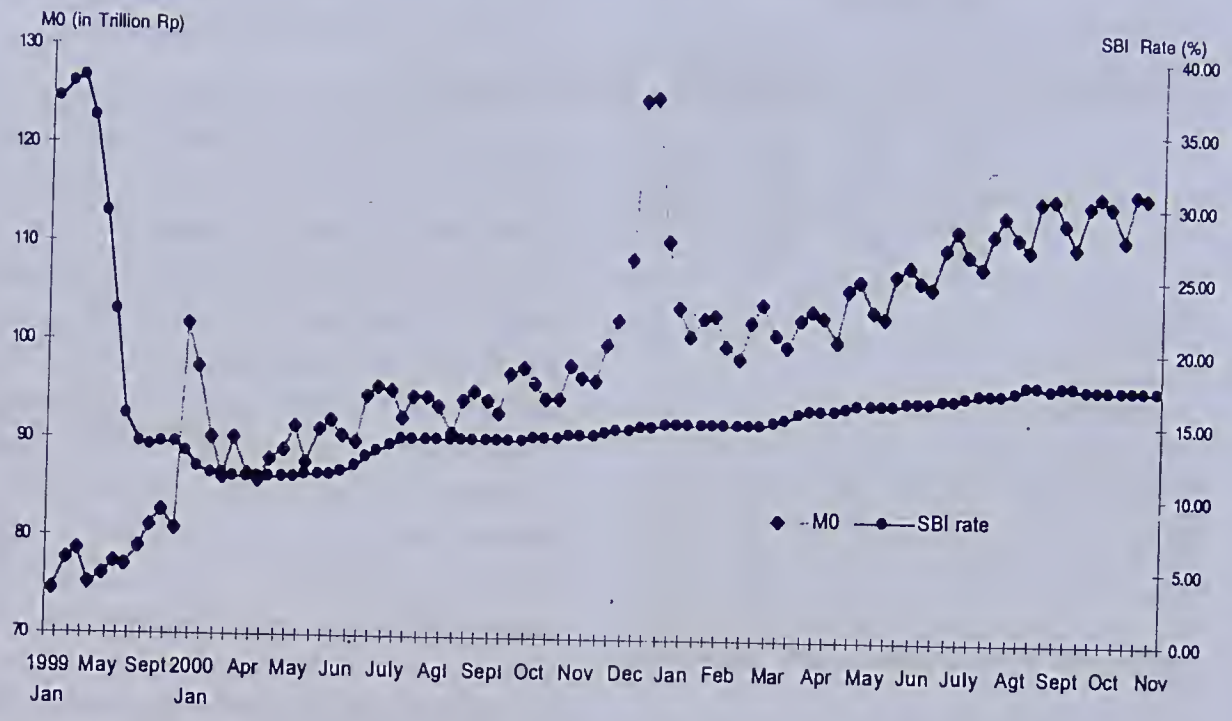
GDP BY EXPENDITURE
(quarter, year-on-year, % change)

	2000				2001		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Private consumption	2.5	3.3	4.0	4.7	5.9	4.8	7.1
Government consumption	2.9	0.3	11.7	12.1	6.0	4.2	11.9
Gross fixed capital formation	13.1	20.7	22.3	15.8	12.9	7.1	(4.3)
Exports	15.1	21.2	14.1	14.2	18.4	17.4	6.6
Imports	5.0	3.9	20.1	44.2	46.6	29.0	(1.7)
GDP	**4.2**	**5.2**	**4.4**	**5.2**	**3.1**	**3.3**	**3.5**

Source: *Berita Resmi Statistik* No. 33/IV/15 November 2001

Chart 1

M0 & SBI RATES JAN 1999 - NOV 2001



Source: Bank Indonesia

the banking and interest rate environment, inflation will remain higher than the government target of 9% next year.

The central bank has progressively increased the SBI (Bank Indonesia Certificate) rate from about 15% at the beginning of the year to nearly 18% in September (see chart above). Higher interest rates increase the cost of domestic-debt servicing for the government, where servicing government bonds already accounts for 17% of already-stretched government expenditures.

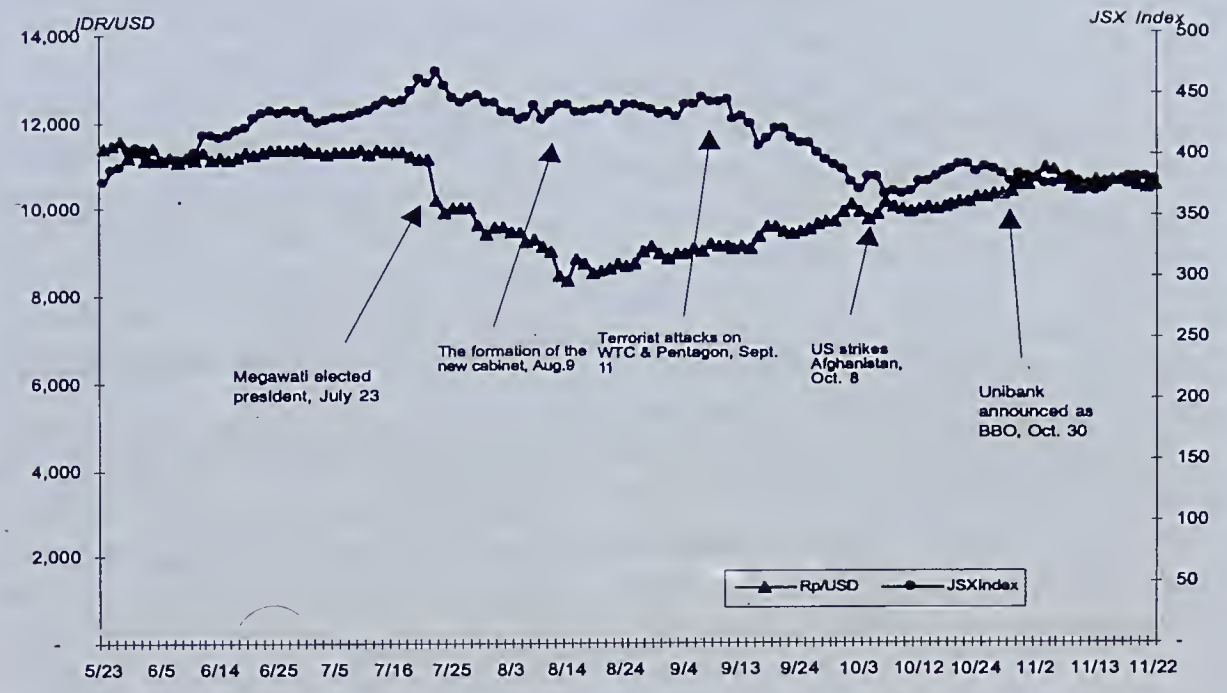
So monetary policy is completely ineffective - Bank Indonesia is overseeing excessive increases in the money supply while implementing a largely symbolic tightening of interest rates. Given the political pressure faced by Bank Indonesia, interest rates are likely to remain flat in the foreseeable future - increasing rates will meet with opposition from government and business, and lowering interest rates would certainly lead to further inflation and currency depreciation.

The Rupiah and the Stock Market

The new government's failure to press ahead with economic reform together with the excessive growth in the base money supply, has caused the currency to depreciate further. The exchange rate has deteriorated to Rp 10,500/US$ in November

Chart 2

RUPIAH PERFORMANCE AND JSX INDEX



Source: IDR/USD: Pacific Exchange Rate Service, University of British Columbia, http://pacific.commerce.ubc.ca/xr

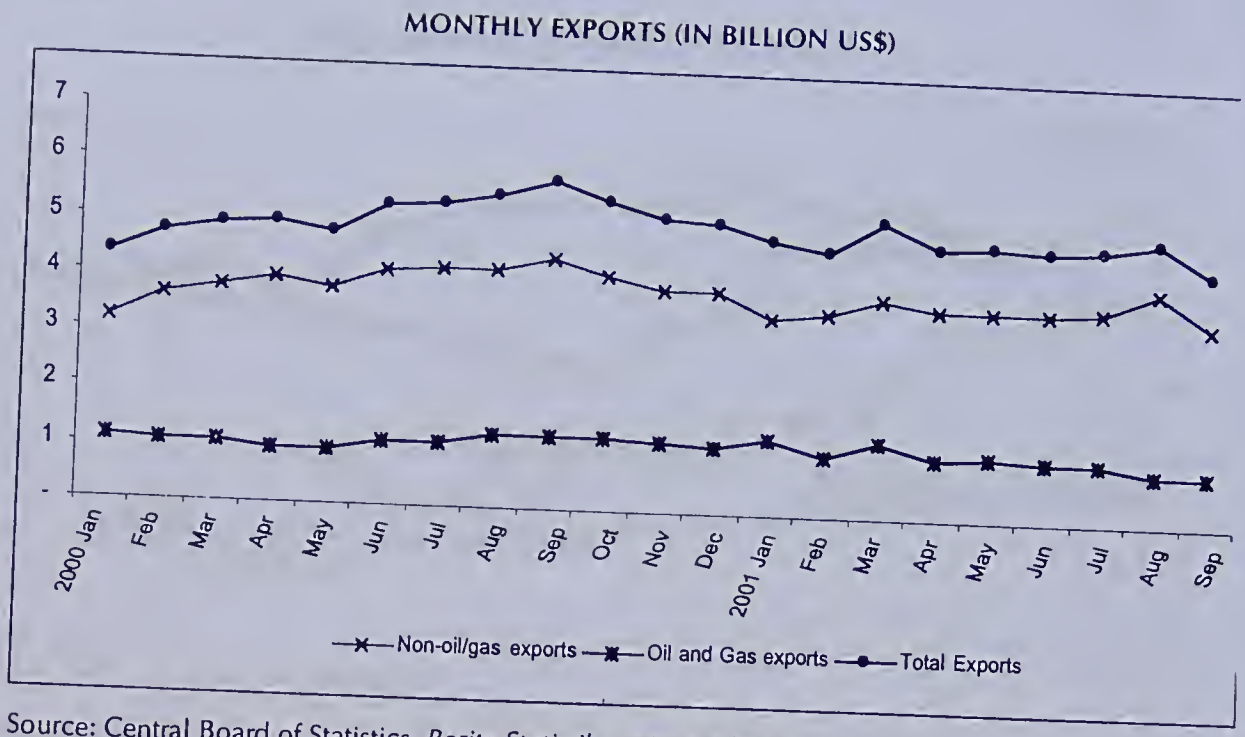
IHSG: JSX Monthly Statistics.

after strengthening to Rp 8,500/US$ when Megawati was instated as President.

While the short-run prospect for the exchange rate depends more on political and security conditions, the medium- and long-term prospect depends on the monetary fundamentals. Since neither market sentiment nor monetary policy look like improving in the short run, the Rupiah will probably hover around Rp 11,000/US$ in the next three months.

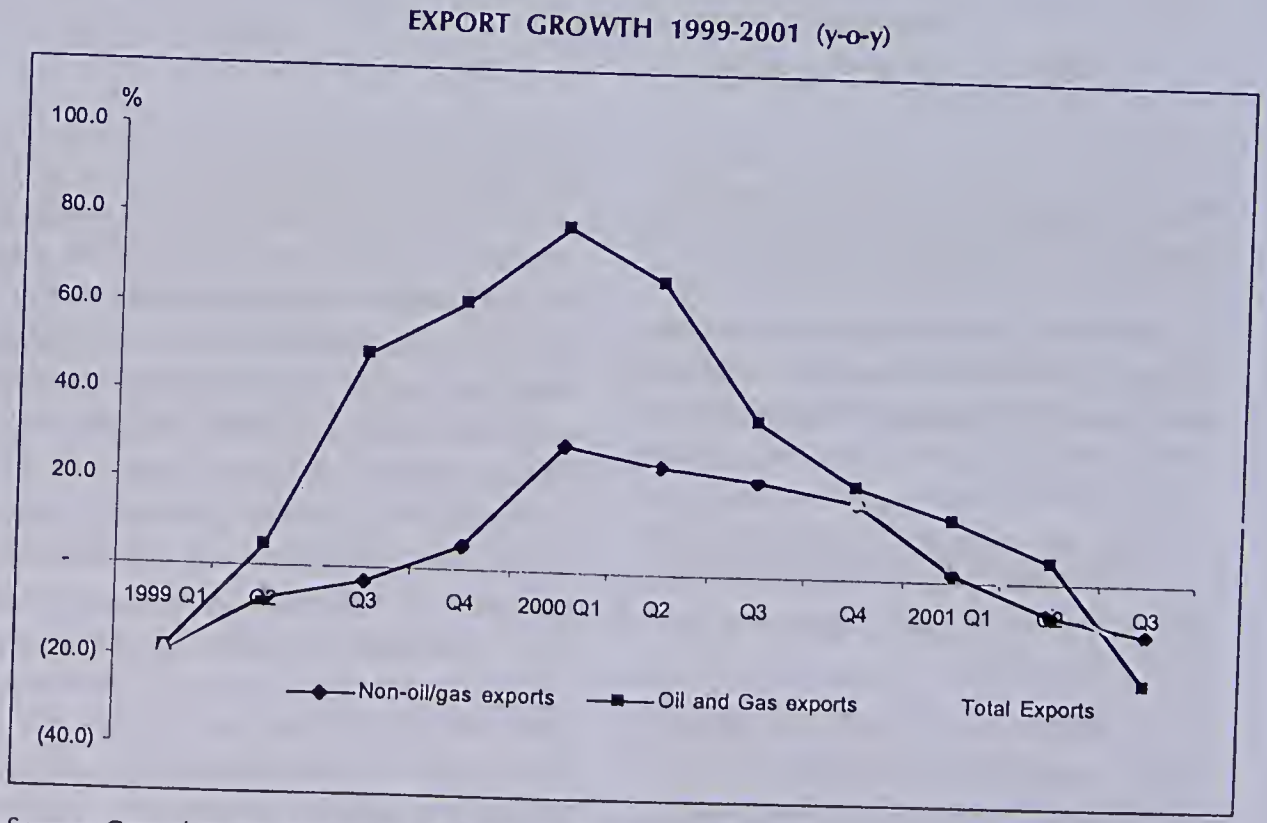
In the past few months, heightened political uncertainty in the wake of the terrorist attacks in the U.S., the poor performance of stock markets worldwide, and the uncertainty overhanging the government's reform agenda, have damped the stock market. After increasing from 400 to around 440 with the instalment of the new administration in August, the Jakarta Composite Index declined to around 380-390 in October, and to 360-380 in November. Capital markets are likely to remain wary of the performance of the new cabinet, especially given the slow progress on asset sales and restructuring. Foreign investors' wait-and-see approach to the new government, and expectations that interest rates will remain high for a while, will prevent any significant increases in the index in the next few months.

Chart 3



Source: Central Board of Statistics, *Berita Statistik*, various editions.

Chart 4



Source: Central Board of Statistics, *Berita Statistik*, various editions.

Balance of Payments

After reaching US$5.1 billion in August, exports fell to US$4.5 billion in September, the lowest monthly value in the year to September (see Chart 3). Non-oil and gas commodities drove the export plunge, while oil-and-gas exports were relatively stable. All of Indonesia's largest export items declined in September, with a dramatic decline in 'machinery and electrical equipment' suffers the biggest impact.

The export outlook for next year is even worse. Nearly half of Indonesia's non-oil and gas exports go to three destinations - the U.S.A., Japan, and Singapore. Given these countries are all experiencing a significant economic downturn, which is likely to continue into the first half of 2002, demand for Indonesia's exports will probably deteriorate.

Moreover, slow progress on domestic reforms and security issues, especially in the wake of the September bombings, are hampering exports. As a result of recent international developments, some Indonesian exporters have said they are expecting a 30-50% reduction in exports in the last few months of 2001. There was a 50% drop in trade agreements signed during Indonesia's annual trade expo in October, largely because international buyers stayed away with reports of anti-Western sentiment in Indonesia. According to various industry associates, some exporters of manufactured goods have not received any export orders for January 2002, which would normally be in place by now.

In the nine months to September, imports were US$24.7 billion, compared with US$23.3 billion in the same period last year. But unlike last year, which saw a major fillip in exports in the last half of the year, imports declined by 18% in the third quarter of this year (see Chart 5). A 20% depreciation of the Rupiah/US$ exchange rate this year[1], and slower domestic growth (3.5% forecast for this year compared with 4.8% last year) have caused imports to decline.

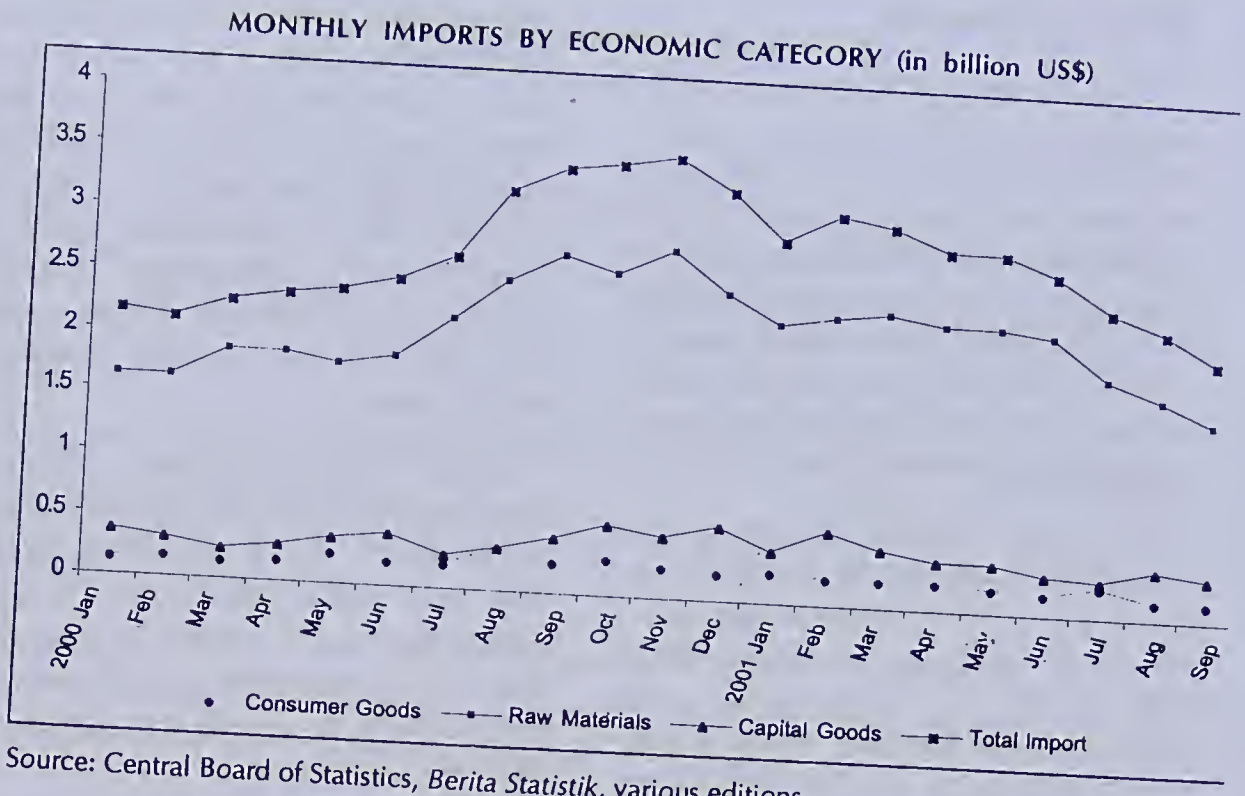
By commodity classification, in the first nine months of 2001, 77% of imports were raw materials and intermediate inputs; 16% were capital goods and 7% were consumption goods. Imports of raw materials and intermediate inputs were the main source of the decline in imports in the September quarter.

Capital Account: Net Capital Outflows

The massive outflow of private capital in the past few years is continuing. In the first half of the year, the net private capital outflow was about US$5 billion; 80% of which was foreign direct investment. Meanwhile, the inflow of 'official' capital (loans) was only slightly higher than official debt repayments. So overall the capital account is haemorrhaging, with little respite in sight. Standard and Poors recently downgraded Indonesia's sovereign credit rating to CCC; official creditors have stepped up the conditionality of their loans (see section, "International financial institutions"); and foreign investors are facing a poor investment environment.

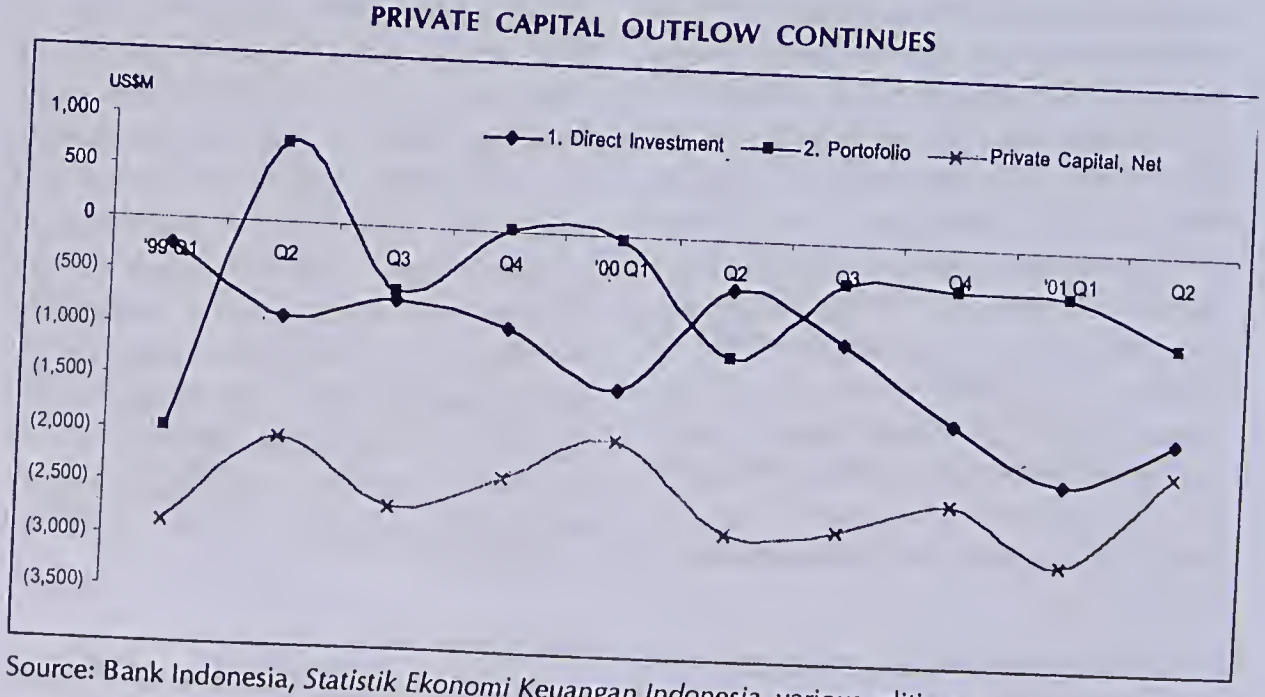
[1]Taking the average Rp/US$ rate for this year and comparing it with the average for last year.

Chart 5



Source: Central Board of Statistics, *Berita Statistik*, various editions.

Chart 6



Source: Bank Indonesia, *Statistik Ekonomi Keuangan Indonesia*, various editions.

FISCAL DEVELOPMENTS

2001 Government Budget: Financing Shortfall?

After introducing major budget revisions earlier in the year to rein in the deficit, which had burgeoned from 3.7% of GDP (Rp 52.5 trillion) to 6.5% of GDP, the government is now facing a deficit-financing problem. While the government says the budget deficit will be the forecast 3.7% of GDP, a significant portion of the budget deficit is yet to be financed.

In terms of foreign financing, loan disbursements from the Asian Development Bank (ADB) and the World Bank are under threat because the government has failed to meet key reform requirements. While the cancellation of these loans is a blow to the country, they will mean little to budget-deficit financing because there will be a commensurate decline in planned development spending.

More worrying is the shortfall of domestic financing of this year's budget deficit, which could exceed 25% of the forecast deficit. The government had expected to earn Rp 6.5 trillion from the privatization of various state firms, none of which have been sold. In addition, by the end of the year, the government was meant to sell its 51% share in Semen Gresik worth about Rp 5.2 trillion. After expiring in October, the government has now decided to try to change the terms of the put option by requesting that it use Rp 3.2 trillion of the Rp 5.2 trillion expected from the sale to purchase a controlling share in two of Semen Gresik's subsidiaries, which local authorities want to see in state hands. The government is running out of time to negotiate any deal, let alone this apparently unpopular one.

As one response to the deficit-financing problem, the government has just announced that it will sell a small amount of discounted government bonds to the regions. While 'fluid' accounting such as this might see the budget balance this year, it will only add to the burden of next year's budget, which is already overburdened.

2002 State Budget: Through Parliament

At the end of October, the parliament finally approved the state budget for 2002, which is still targeted to be 2.5% of GDP (Rp 42.1 trillion instead of Rp 43 trillion as initially planned) after some revisions to the budget's economic indicators, expenditures and revenues.

A slower global, economic outlook for next year has made the government revise its budget assumptions. The new economic indicators are a little more realistic but still optimistic. In the approved budget, economic growth was revised down from 5% to 4%; the inflation rate increased from 8% to 9%; the exchange rate is assumed to be slightly weaker, Rp 9,000/US$ instead of Rp 8,500/US$. Official interest rates are still forecast to be 14%, compared with 18% now. And oil production is now forecast to be 1.32 million barrels per day instead of 1.2 million barrels per day, the current output level. The oil-price forecast is still US$22/barrel compared with around US$19/barrel now.

Total government expenditure in the actual budget is 3.5% higher than in the draft budget. To meet the increase in expenditure, the government plans to increase both tax and non-tax revenues. The sudden inclusion of higher oil output in

the budget is the non-tax revenues, which is a disappointing turnaround in policy, as the new government had said it was trying to reduce its reliance on limited natural resources for budgetary revenue. Minister of Finance Boediono recently talked about a contingency fund to meet any shortfall in planned oil revenues next year. It is not clear where this fund will come from exactly, especially since other planned revenues are in doubt.

In terms of financing the budget deficit, IBRA's contribution from asset sales is assumed to be 9% less and foreign financing is 6% higher than originally planned. Unless the new government improves its poor performance on economic reform, increases in foreign financing will be unlikely.

Overall, the revisions to the 2002 budget have meant tweaking the numbers to provide a few extra political sweeteners. But most of the budget estimates are still optimistic. And the large amount of foreign financing on which the budget depends will only be forthcoming if the government is prepared to undertake a tough reform agenda, which so far it has failed to do.

Updates on the International Donor Community

According to a World Bank report preceding the Consultative Group on Indonesia (CGI) meeting in November, Indonesia's failure to meet reform targets may inhibit donor countries from giving the loan support that Indonesia needs to finance next year's state budget. Despite the World Bank statements, the CGI has pledged a total of US$ 3.14 billion in loans and US$386 million in grants and technical aid in a meeting in Jakarta, November 7-8. The loan and grant pledges were to help cover the country's 2002 state budget deficit at 2.5% of GDP. The loan amount, however, marked a sharp decline from last year's pledge of US$4.7 billion. However, this commitment may not reflect that the CGI and international community have fully restored their confidence in Indonesia. As in previous years, disbursement from ongoing and new program loans pledged in the CGI will be conditional on policy performance. So the CGI's recent commitment should not be a foregone conclusion.

The government signed its fourth Letter of Intent (LoI) to the IMF on Thursday, but the disbursement of the long-delayed US$ 360 million loan tranche is still on hold. The government is required to sign a new LoI after it failed to achieve several targets outlined in the previous one. Therefore, the latest LoI is basically similar with the previous one. It covers four broad areas: (1) fiscal and monetary policy, (2) financial sector reforms, (3) privatization, asset recovery and debt restructuring and, (4) governance, legal and other structural reforms. Among the macroeconomic targets for 2002 are: economic growth of 3-4%; inflation below 9-10%; and a budget deficit of no more than 2.5% of GDP.

The three-year contract with the IMF is due to end by December 2002. However, the government has requested to extend its IMF-monitored economic program by a year to December 2003. Indonesia must be participating in an IMF-monitored program if it is to seek rescheduling at next year's third Paris Club meeting, which will discuss the repayment of Indonesia's sovereign debt. At this meeting, the government will seek to reschedule US$4 billion in loans falling due in April 2002 - December 2003.

Some Determinants of the Female and Male Labour Force's Participation in Indonesia

Tubagus Feridhanusetyawan,
Haryo Aswicahyono, Ari A. Perdana

INTRODUCTION

THE end of oil boom in the early 1980s marked the beginning of a new era for the Indonesian economy-the era of economic liberalization-characterized by progressive openness in trade, investment and finance. The liberalization, especially within the period of 1986 onwards, had accelerated the pace of economic transformation leading to massive structural changes in the Indonesian economy. Economic growth was steadily ranging at around 7-8% annually, while single digit inflation could be maintained. Trade balance increased significantly in spite of the widening current account deficit due to the large capital inflows in the mid-1990s.[1] The economic development during the liberalization period had also benefited Indonesian workers significantly. Employment in the formal sectors has grown at around 7% per annum during 1986-1997. Average workers' income in the formal sectors has increased significantly at the rate of around 6% during 1989-1997. Given the changes taking place in the labor market during the liberalization period, there are two main questions to be addressed in this study. The first question is how women have participated in the Indonesian labor market relative to that of men. Women participation increased markedly both absolutely and relatively to men. In the 1970s Female LFP rate (LFPR) was around 30%. By 1986, just about half of the working age women population had entered the workforce. Unfortunately, the trend halted in 1986.

Since then, women participation rate has been steady at around 50-51%. The second question concerns the reason behind the lower female LFPR relative to the male. The analysis is conducted to see whether the lower female LFPR is due to the relatively lower productivity of female labor or whether there are structural barriers -including discrimination- for women to enter the labor market. Conceptually, labor market discrimination exists when the probability of a female individual to enter the

[1]For further discussion, see Feridhanusetyawan (2000), Hill (1996) and Pangestu (1996).

labor market is significantly lower than a male individual with equal characteristics. However, it is not discrimination when the difference in probability is the result of difference in endowments (e.g.,lower education level).

The primary purpose of this paper is to examine the gender differentiated impacts of tremendous change in the economic and demographic structure on the labor market in Indonesia. To be more specific, the objectives of this study are: (1) to provide empirical estimates of parameters and factors that matters in determining LFP for male and female individuals; and, (2) to measure the presence of gender-based discrimination in the difference between male-female LFP. The study covers the dynamics of female and male LFP in 1986, 1990, and 1997, based on the Sakernas (*Survey Tenaga Kerja Nasional*/National Labor Force Survey) micro data, an annual survey data issued by the Central Board of Statistics (CBS).[2] The selected years are chosen to represent the period of rapid economic liberalization from mid 1980s to late 1990s, just before the economic crisis took place.

The discussion of this article starts with the methodology used to conduct the study in the second section. This includes the general framework of analysis, the empirical estimation procedure and the decomposition analysis of gender-based discrimination. The estimation result is presented in the third section. The paper also presents the empirical estimations on the determinants of the LFP and the result of the decomposition analysis. Finally, the study is concluded in the final section.

METHODOLOGY

Framework of Analysis

The coverage of study is focused on the Labor Force Participation (LFP) rate as the independent variables, which is aimed at identifying important variables that influence LFP rates of both male and female labors. Given the relevant dependent and the independent variables, the study proceeds with econometric estimation of the determinant of LFP rate for male and female. A gender-based decomposition analysis is then conducted, following econometric estimations of LFP and earnings equations. This gender-based decomposition would specifically provide empirical estimate of factors that lead to the difference in LFP between males and females.

The investigation is based on several hypotheses. *First*, the female LFP rate follows an inverted U-shaped pattern over the course of economic development, worsening at the beginning and increasing at the later state. *Second*, the rate and pattern of change in participation rate was the result of the change in the structure of an economy, change in the structure of labor force, and the change in the extent of gender bias. *Third*, the smaller gap between male and female LFP is assumed due to both higher endowment levels of the females, such as higher education, and smaller discrimination against female labor in the labor market.

[2]The *Sakernas* data are taken on cross-sectional basis, in all provinces nationwide in August each year. The data each year consists of about 250,000 observations in urban and rural areas.

Table 1

VARIABLE DEFINITION

Variable	*Description*
Dependent Variable	
LFP	Labor force participation in the wage-sector; LFP = 1 if participating in the LF; 0 if not
Independent Variables	
Individual Characteristics	
AGE	Age in years
Family Characteristics	
MAR	Marital status; MAR = 1 if married; 0 if not married
Educational Background	
EDY	Respondent's years of education
Household Head Background	
D	Head of household dummy; d = 1 if head of household; 0 if otherwise
LHHDWAGE *	Log of household head's income
HHDEDY *	Head of household's education in years
HHDSQ *	Square of HHDEDY / 100
	* *value set as zero if the respondent is a household head*
Regional Dummies (Other Region in Java = control)	
REG1	Jabotabek (Greater Jakarta)
REG2	West Java excl. Jabotabek
REG3	Semarang, Solo, Yogyakarta, Surabaya
REG4	Other Regions in Central Java
REG5	North, West Sumatera
REG6	Other Sumatera
REG7	Kalimantan
REG8	Maluku, Papua, East NT, East Timor, N Sulawesi
REG9	Other Regions in Eastern Indonesia

Table 2

MEAN VALUES OF VARIABLES IN THE PROBIT EQUATIONS

	1986				1990				1997			
	URBAN		RURAL		URBAN		RURAL		URBAN		RURAL	
Variables	Female	Male	Female	Male	Female	Male	Female	Male	Female	Male	Female	Male
LFP	0.29	0.58	0.51	0.74	0.32	0.60	0.51	0.75	0.39	0.67	0.49	0.76
AGE	29.96	29.75	31.13	31.05	30.32	30.32	31.81	31.65	31.69	31.66	33.13	32.96
MAR	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.50	0.51	0.58	0.58
CHILD	1.22	1.19	1.34	1.34	1.04	1.02	1.17	1.16	0.82	0.80	0.96	0.96
EDY	6.30	7.53	4.07	5.06	6.78	7.89	4.46	5.38	7.67	8.55	5.19	6.01
D	0.07	0.45	0.07	0.52	0.07	0.46	0.08	0.52	0.07	0.50	0.07	0.55
LHHDWAGE	4.94	2.67	1.77	0.83	1.90	3.01	1.08	1.00	5.37	2.60	2.64	1.13
HHDEDY	7.09	4.07	4.19	2.05	4.93	4.39	2.45	2.39	8.01	4.11	5.18	2.34
REG1	0.12	0.13	0.03	0.03	0.15	0.15	0.02	0.02	0.15	0.16	0.02	0.02
REG2	0.09	0.09	0.10	0.10	0.08	0.08	0.10	0.10	0.07	0.07	0.10	0.10
REG3	0.07	0.07	0.00	0.00	0.05	0.05	0.00	0.00	0.05	0.05	0.00	0.00
REG4	0.12	0.11	0.15	0.15	0.12	0.11	0.15	0.15	0.12	0.12	0.15	0.15
REG5	0.07	0.07	0.08	0.07	0.07	0.07	0.08	0.08	0.07	0.07	0.08	0.08
REG6	0.15	0.15	0.16	0.16	0.14	0.15	0.16	0.17	0.14	0.15	0.16	0.17
REG7	0.08	0.09	0.09	0.10	0.09	0.09	0.09	0.10	0.08	0.09	0.09	0.10
REG8	0.09	0.09	0.11	0.12	0.08	0.08	0.11	0.12	0.08	0.08	0.11	0.11
REG9	0.14	0.14	0.14	0.13	0.14	0.14	0.14	0.13	0.14	0.13	0.14	0.13

Conceptually, the observed differences in workforce participation between male and female could be attributed to the differences in endowments and structural factors in the labor market supply and demand. The differences in endowments, or *endowment effects*, include the relative level of education, experiences, and in other productivity-related characteristics. The structural factors, or *structural effects*, in the labor market can be analyzed from the supply and demand sides. On the supply side, structural factors are influenced by, among other things, differences in household characteristics as well as differences in employment preferences and time constraint. On the demand side, structural factors are determined by several factors, such as size of the market and other regional characteristics. Decomposing male-female differences in LFP into these two factors may elucidate the importance of each factor in explaining the differences in male-female LFP and in providing guidance for public policy making. For example, the decomposition result will indicate in what area the policy makers should focus their attention, in enhancing productive endowments or in reducing barriers created by labor market structural factors.

The econometric model that represents various factors determining the participation in the labor market is estimated by using the standard Probit model and estimation procedure.[3] The model assumes that each individual has two choices: to participate or not to participate in the labor market. Individual makes his or her best and rational decision by comparing the utility of being in the labor force or that of otherwise. The probability of choosing one alternative depends on his or her personal characteristics, family characteristics especially the head of the household, and regional characteristics. Table 1 and 2 present the definitions and descriptive statistics of the variables that are used in the model. Note that the 1986 and 1990 *Sakernas* does not present the information of marital status. The dependent variable, LFP is set equal to one if the individual participates in the job market, either in the formal or informal sector, or even still looks for a job or unemployed. The dependent variables in general consist of personal characteristics, family characteristics, and regional characteristics. Personal characteristic that matter in determining LFP includes age, education, marital status, and number of children. The family characteristics are basically the characteristics of the head of households, such as education and income.

Decomposition Analysis

The model described previously is a selection model in which the individual employment choice is based on the comparison between the utility of working and that of not working. However, it could not shed light on the source of gender differences in LFP. To disentangle the source of observed gender differences in LFP, the male-female differences in LFP are decomposed using the method proposed by Jones (1986):

[3]See Greene (1994) or Maddala (1983) for Probit estimation procedure.

$$(1)\quad \bar{E}_M - \bar{E}_F = \left[\Phi\left(\bar{X}_M\hat{\beta}_M\right) - \Phi\left(\bar{X}_F\hat{\beta}_M\right)\right] + \left[\Phi\left(\bar{X}_F\hat{\beta}_M\right) - \Phi\left(\bar{X}_F\hat{\beta}_F\right)\right]$$

Where E represents the LFP of males *(m)* and females *(f)*, X is vector of the average values of the explanatory variables used in LFP equations, and the β's are the estimated coefficients capturing gender-specific labor market structural forces. The first term on the right-hand side of equation (1) measures the extent to which LFP differentials between men and women can be explained by the differences in men's and women's endowments. In other words, it calculates the difference between men's predicted LFP and the level of women's LFP if women were endowed with the same characteristics as men. The second terms can be attributed to the influence of structural demand-and-supply factors on gender differences in LFP. Since this term is a residual, it also captures unobserved factors that are not equally distributed among men and women such as individual taste and preferences for employment. It may also capture societal discrimination in labor market.

The first and the second components of (1) can be further decomposed into j sub-components. The fraction of endowment effects (the first term in the equation [1]) explained by gender differences in j^{th} variables can be estimated by:

$$(2)\quad \Delta X_j = \left[\Phi\left(\bar{X}_M\hat{\beta}_M\right) - \Phi\left(\bar{X}_F\hat{\beta}_M\right)\right]\left[\left(\bar{X}_M - \bar{X}_F\right)\hat{\beta}_M\right] \Big/ \left[\left(\bar{X}_M - \bar{X}_F\right)'\hat{\beta}_M\right]$$

Similarly, the fraction of structural effects (the second term) explained by gender differences in jth coefficients is given by:

$$(3)\quad \Delta\beta_j = \left[\Phi\left(\bar{X}_M\hat{\beta}_M\right) - \Phi\left(\bar{X}_F\hat{\beta}_M\right)\right]\left[\left(\hat{\beta}_M - \hat{\beta}_F\right)\bar{X}_F\right] \Big/ \left[\left(\hat{\beta}_M - \hat{\beta}_F\right)\bar{X}_F\right]$$

By decomposing further the two components of (1) into j sub-components, we can analyze the importance of each individual variable or coefficient in explaining the predicted male-female differences in LFP.

DETERMINANTS OF THE FEMALE AND MALE LFP

Probit estimates of the male and female LFP in 1986, 1990 and 1997 are presented in Tables 3, 4, and 5. In addition to the estimated coefficient and *t*-statistics, the marginal effects evaluated at means are also presented in the tables.[4] The values of *t*-statistics, which are greater than 1.96 in general basically show the quality of the estimated parameters.

Age

The impact of age on determining the LFP rate is significant, and the quadratic inverted U-shape pattern is obtained. LFP rates increase when people get older, reach the peak at a certain age, and then decline afterwards. The results suggest that LFPR is highest at the age group of 39-40 and 42-43 years for female and male respectively. The situation is generally similar for 1986 and 1990, but in 1997 the LFPR curve for female reaches the peak at the age of 42-43. This illustrates that women tend to stay longer in the labor market.

[4]The value of the marginal effect is calculated as: $\partial LFP / \partial X = \beta \cdot f(X'\beta)$ evaluated at means on X, where f is the normal density function.

Table 3

PROBIT ESTIMATES OF LFP, 1986

	FEMALE						MALE					
	Urban			Rural			Urban			Rural		
	BETA	T-stat	M.E.	BETA	T-stat	M.E.	BETA	T-stat	M.E.	BETA	T-stat	M.E.
AGE	0.12	47.8	0.9	0.31	79.0	3.3	0.14	105.5	1.2	0.24	109.7	1.4
AGE2	-0.16	-44.7		-0.37	-79.7		-0.17	-98.7		-0.28	-111.8	
MAR	-	-	-	-	-	-	-	-	-	-	-	-
CHILD	-0.04	-6.8	-1.4	0.09	11.2	3.5	-0.05	-13.1	-2.0	0.01	2.8	0.3
EDY	-0.12	-16.9	0.8	-0.13	-11.1	-4.9	-0.03	-7.6	0.4	0.03	4.0	0.1
EDSQ	1.20	23.5		0.86	11.7		0.54	13.3		-0.20	-3.8	
D	0.43	9.5	0.9	0.30	5.7	11.5	0.39	17.0	15.7	0.24	7.9	5.2
LHHDWAGE	-0.02	-13.4	-0.7	-0.01	-3.5	-0.8	-0.03	-20.6	-1.9	-0.03	-13.0	-0.6
HHDEDY	-0.02	-3.3	-4.2	-0.04	-6.7	-2.1	-0.04	-10.7	-1.7	-0.06	-16.3	-1.4
HHDSQ	-0.05	-1.3	0.0	-0.23	-7.0	0.0	-0.04	-1.4	0.0	0.00	-0.1	0.0
REG1	-0.57	-15.8	-18.2	-0.02	-0.5	-0.9	-0.78	-23.9	-31.0	-0.34	-8.6	-7.4
REG2	-0.39	-10.3	-12.4	-0.09	-1.8	-3.3	-0.27	-14.7	-11.0	-0.25	-10.2	-5.5
REG3	-0.39	-9.7	-12.4	-0.30	-5.8	-11.2	-0.27	-3.7	-10.6	-0.53	-5.6	-11.4
REG4	0.08	2.3	2.5	-0.07	-1.5	-2.5	0.24	14.4	9.5	0.05	2.3	1.1
REG5	-0.39	-9.7	-12.5	-0.15	-2.8	-5.5	0.09	4.2	3.4	-0.16	-6.1	-3.5
REG6	-0.51	-14.8	-16.2	-0.12	-2.8	-4.5	-0.07	-4.1	-2.7	-0.18	-8.5	-3.9
REG7	-0.40	-10.2	-12.5	-0.07	-1.4	-2.6	0.15	8.0	6.0	0.04	2.0	0.9
REG8	-0.22	-5.8	-7.0	0.00	-0.1	-0.2	0.01	0.5	0.3	-0.12	-5.4	-2.6
REG9	-0.33	-9.6	-10.4	-0.17	-3.9	-6.5	-0.09	-6.7	-3.7	-0.04	-2.4	-1.0
CONSTANT	-1.80	-31.8	-57.0	-4.00	-50.6	-150.9	-1.90	-69.6	-75.9	-2.84	-70.3	-61.2
Number of observations (in percentage)												
Total	32549	(100)		32240	(100)		83698	(100)		81528	(100)	
LFP = 1	9377	(29)		18818	(58)		42577	(51)		60616	(74)	

Table 4

PROBIT ESTIMATES OF LFP, 1990

	FEMALE						MALE					
	Urban			Rural			Urban			Rural		
	BETA	T-stat	M.E.	BETA	T-stat	M.E.	BETA	T-stat	M.E.	BETA	T-stat	M.E.
AGE	0.12	68.8	0.9	0.30	110.5	3.0	0.14	107.2	1.2	0.23	109.8	1.4
AGE2	-0.15	-64.0		-0.35	-111.5		-0.17	-98.8		-0.27	-111.5	
MAR	-	-	-	-	-	-	-	-	-	-	-	-
CHILD	-0.06	-12.9	-2.2	0.10	15.3	3.6	-0.07	-16.3	-2.6	-0.01	-1.7	0.3
EDY	-0.15	-28.7	0.4	-0.08	-9.9	-0.2	-0.02	-5.1	-0.1	0.06	10.5	0.1
EDSQ	1.21	35.2	0.0	0.50	9.7		0.20	5.6	0.0	-0.45	-10.0	
D	0.64	22.4	21.8	0.37	8.6	13.5	0.57	25.2	22.7	0.50	15.2	5.2
LHHDWAGE	0.01	3.6	0.2	0.00	-1.0	-0.1	0.00	-3.1	-0.2	-0.01	-3.0	-0.6
HHDEDY	0.01	2.8	-0.1	-0.02	-5.4	-1.1	-0.02	-4.7	-0.5	-0.02	-4.6	-1.4
HHDSQ	-0.12	-5.0	0.0	-0.08	-3.5	0.0	0.09	2.6	0.0	-0.06	-2.0	0.0
REG1	-0.44	-18.9	-15.0	-0.10	-3.2	-3.5	-0.63	-16.6	-25.2	-0.22	-4.9	-7.4
REG2	-0.32	-11.7	-10.7	-0.10	-2.9	-3.6	-0.26	-13.9	-10.4	-0.20	-8.4	-5.5
REG3	-0.13	-4.4	-4.3	-0.30	-8.0	-10.9	0.30	3.9	12.0	-0.13	-1.3	-11.4
REG4	0.16	6.9	5.4	0.03	1.0	1.1	0.26	15.8	10.5	0.10	4.6	1.1
REG5	-0.25	-8.9	-8.4	-0.19	-5.3	-6.8	0.19	9.1	7.6	-0.16	-6.0	-3.5
REG6	-0.50	-20.9	-17.0	-0.15	-5.1	-5.5	0.06	3.6	2.4	-0.08	-4.0	-3.9
REG7	-0.35	-13.2	-11.7	-0.12	-3.7	-4.5	0.24	12.5	9.7	0.03	1.5	0.9
REG8	-0.33	-11.8	-11.0	-0.22	-6.6	-8.1	0.14	7.8	5.7	-0.02	-0.8	-2.6
REG9	-1.85	-48.4	-62.7	-4.09	-72.0	-148.3	-2.20	-79.1	-87.9	-3.11	-75.0	-61.2
CONSTANT	-1.80	-31.8	-57.0	-4.00	-50.6	-150.9	-1.90	-69.6	-75.9	-2.84	-70.3	-61.2
Number of observations (in percentage)												
Total	64271		(100)	63022		(100)	82407		(100)	81050		(100)
LFP = 1	20284		(32)	38109		(60)	41747		(51)	60844		(75)

Table 5

PROBIT ESTIMATES OF LFP, 1997

	FEMALE						MALE					
	Urban			Rural			Urban			Rural		
	BETA	T-stat	M.E.	BETA	T-stat	M.E.	BETA	T-stat	M.E.	BETA	T-stat	M.E.
AGE	0.17	64.4	1.5	0.25	78.3	1.8	0.14	72.5	1.3	0.23	82.5	1.1
AGE2	-0.20	-62.3		-0.31	-83.5		-0.17	-70.0		-0.26	-85.7	
MAR	-0.56	-30.2	-21.0	0.52	16.5	16.1	-0.09	-5.8	-3.7	0.46	14.8	8.9
CHILD	-0.05	-7.3	-1.8	0.10	10.4	3.0	-0.07	-12.4	-2.7	0.01	0.6	0.1
EDY	-0.12	-18.3	2.3	-0.10	-9.6	2.3	-0.03	-5.9	1.1	0.05	5.9	1.0
EDSQ	1.19	29.9		1.02	16.3		0.56	14.1		0.01	0.2	
D	-0.02	-0.5	-0.8	0.41	7.6	12.7	0.31	10.2	12.5	0.18	4.1	3.5
LHHDWAGE	-0.02	-13.4	-0.6	-0.01	-3.3	-0.5	-0.02	-16.2	-0.8	-0.01	-5.9	-0.2
HHDEDY	-0.01	-1.8	-1.1	0.01	2.9	-1.0	-0.03	-6.9	-1.6	-0.02	-4.0	-0.8
HHDSQ	-0.13	-4.7	0.0	-0.58	-20.9	0.0	-0.09	-2.9	0.0	-0.44	-12.8	0.0
REG1	-0.37	-13.8	-13.8	-0.08	-2.1	-2.3	-0.72	-16.6	-28.6	-0.30	-5.6	-5.9
REG2	-0.28	-9.0	-10.7	-0.04	-0.9	-1.2	-0.32	-14.4	-12.7	-0.16	-5.1	-3.2
REG3	-0.08	-2.3	-3.0	-0.18	-3.9	-5.6	0.42	4.7	16.5	0.04	0.3	0.8
REG4	0.12	4.5	4.6	-0.02	-0.7	-0.8	0.16	8.1	6.4	0.00	0.1	0.0
REG5	-0.15	-4.6	-5.5	-0.02	-0.4	-0.6	0.26	10.6	10.3	-0.01	-0.3	-0.2
REG6	-0.31	-11.5	-11.7	0.02	0.6	0.7	0.02	1.0	0.8	0.04	1.4	0.8
REG7	-0.24	-8.0	-9.0	-0.03	-0.8	-1.0	0.22	0.0	8.9	0.15	4.5	2.9
REG8	-0.20	-6.4	-7.4	-0.14	-3.3	-4.2	0.08	3.7	3.2	0.11	3.3	2.1
REG9	-0.07	-2.8	-2.8	0.00	0.0	0.0	0.13	6.4	5.2	0.17	5.7	3.4
CONSTANT	-2.29	-44.5	-85.9	-3.50	-50.5	-108.2	-2.21	-60.1	-88.2	-3.24	-59.2	-63.4
Number of observations (in percentage)												
Total	48101	(100)		47116	(100)		62797	(100)		61412	(100)	
LFP = 1	18702	(39)		31530	(67)		30978	(49)		46507	(76)	

The marginal effects are generally greater for male in urban areas. For example, evaluated at the mean value of age, a year increase in age led to around 3% increase in the probability of male entering the labor force in 1986 and 1990. The marginal effect in 1997 was smaller, or in other words the LFP curve seemed to be flatter with respect to age.

Marital Status

There are clear different impacts of marital status on the female and male LFP. The estimation results based on 1997 data show that being married significantly reduces the chance for women -and increase the probability for men- to participate in the labor market.[5] This finding bears out the division of labor within household - as the income earner, husbands work in the market sectors while wives are domestic (non-market) labors.

The marginal effects of marital status on LFPR are greater in urban areas than in rural areas. In urban areas, being married reduces the chance of women participating in the labor market by 21% and increases the probability of men entering the labor markets by 16.1%. In rural areas, the marginal effects are minus 5.8% and 8.9% respectively. The finding may suggest that

[5]Sakernas micro data 1986 and 1990 do not have any data on marital status.

the household division of labor hypothesis is more an urban *vis-à-vis* modern sector phenomenon.

Number of Children

The impact of number of children on LFPR is also different for male and female. The number of children clearly reduces the probability of entering the job market for women and increases the chance for men. For women, the effects of the number of children on LFP are stronger in rural areas. Having one more child would lead to the decrease in the probability of women entering the labor market by around 2.0 to 2.7%. In urban areas, the marginal effect is estimated at around minus 1.4 to minus 2.2%. The smaller impact of the number of children on female LFPR in urban areas is expected because the availability of housemaid and servants in urban households. This result in general is consistent with that of Widarti (1998), which shows that the presence of children under five years of age reduces the probability of women entering the labor market. For men, the marginal effects tend to be higher in urban areas and could reach as high as 3.6%.

Education

The estimated model of LFP clearly shows that education level plays a significant role in determining LFP. As expected, the impact of education on LFP rates forms a quadratic pattern in general, and the U-shape pattern is clearly more obvious for female rather than male. In other words, the marginal effect of education on female LFP declines for a while as education level increases and then sharply soars after reaching the lowest point. Therefore, the marginal effect is generally positive and larger as the education reaches high school or even university levels. For male, the marginal effect of education of LFPR generally increases, and then declines in higher level of education. There is also an inverted U-shape curve for male as well, even though in general this pattern is less clear and the impact of education on male LFPR could even be linear, rather than quadratic.

Table 6 indicates the estimated marginal effects of education on the probability of entering the labor market, calculated based on the estimated parameters in the Probit equations. The table confirms the notion that the impact of education on female LFPR

Table 6
THE ESTIMATED MARGINAL EFFECTS OF EDUCATION ON LFP (IN PERCENTAGE)

Education (years)	1986				1990				1997			
	URBAN		RURAL		URBAN		RURAL		URBAN		RURAL	
	Female	Male	Female	Male	Female	Male	Female	Male	Female	Male	Female	Male
3	-1.68	-2.51	-0.02	0.47	-2.54	-1.69	-0.31	1.20	-1.54	-1.22	0.08	1.61
6 (Primary)	0.61	-0.87	1.02	0.09	-0.24	-0.74	0.08	0.34	0.72	0.73	1.14	1.64
9 (Jun. high)	2.89	0.77	2.05	-0.30	2.07	0.20	0.47	-0.52	2.98	2.68	2.20	1.66
12 (Sen. high)	5.17	2.41	3.08	-0.68	4.37	1.15	0.85	-1.39	5.24	4.63	3.25	1.69
15 (Tertiary)	7.46	4.04	4.11	-1.07	6.68	2.10	1.24	-2.25	7.50	6.58	4.31	1.72

follows the U-shape (or sometimes exhibit a J-shape) curve. The marginal effect of education on female LFPR is generally negative for an individual who does not finish the primary school. But the marginal effect starts to become positive when education is equal to 6 years (primary school), and the effect becomes even larger when the level of education increases. The estimates show, for example, that having high school education would increase the chance of participation in the labor force by around 4 to 5% for urban females. The comparable effect on female LFPR in rural areas turns out to be weaker at around 1 to 3%.

There seems to be a general trend from the data in 1986 to 1990 that the marginal effect of education of LFP was stronger for female rather than male and for labor force in urban rather than in rural areas.[6] But in 1997, the marginal effects of education on LFP for male and female are similar, even though the effect was still stronger in urban areas. In 1997, for example, the marginal effect (evaluated at means of education) was 2.3% in urban areas, which means that a year of education could increase the LFP in urban areas by 2.3% for both male and female. In rural areas, the impact was 1.1% in 1997. When the education level is 12 years, the marginal effect is even stronger at around 5.2% for male and 4.6% for female in urban areas. The comparable marginal effect for female in urban areas in 1986 was only around 2.4%. The education level that was generally higher in 1997 had explained the larger marginal effects of education in 1997.

Head of Household Characteristics

The estimated Probit equations clearly show that the probability of entering the labor market is generally higher when an individual is a head of household. The sign of the estimated coefficient on the dummy variable indicating whether the individual is the head of the household is generally positive and significantly different from zero. The only exception is in 1997 when the result on urban female group turned out to be statistically insignificant. There is a general trend that in rural areas, the marginal effect of being a head of household on LFPR is greater for women. Being a head of a household basically gives no choice for women in the rural areas to participate in the labor market. The marginal effect could reach as high as 22%. Among the male population, the marginal effect of being a household head on male LFPR is stronger in urban areas at around 11 to 13%.

When the individual is not a head of household, the characteristics of household head turn out to play a significant role in determining individual's decision to participate in the labor market. There are two variables that have been analyzed - earning (wage) and education of the head of household. The impact of earning of the household head on the LFP of household member is generally negative. In other words, higher

[6]When the marginal effects was evaluated at the mean values of education, the value of the marginal effect could be negative because the mean value of education could be smaller than the value of education in which the LFP curve reaches the minimum in a quadratic curve.

household head income leads to smaller probability of household member entering the labor market. This confirms the theory of individual LFP in which fixed income could increase reservation wage and therefore lower the chance and the necessity of taking a job offer.

Interestingly, the impact of household head's education on one's LFP is also negative. This actually contradicts the idea that higher education would make a household head less restrictive to the household members -especially female- to work. However, higher education also means better economic background for the family, so education could also be a proxy for fixed income, and the 'income' effect in this case is larger than the 'socio-cultural' effect in determining the LFP of family members.

GENDER-BASED DECOMPOSITION OF THE LFP

In urban areas the LFP gap between female and male has been narrowing

Table 7

DECOMPOSITION ANALYSIS OF GENDER DIFFERENCES IN EMPLOYMENT DECISION

	URBAN						RURAL					
	1986		1997		1986-97		1986		1997		1986-97	
Male LFP	63.2		69.2		6.0		86.6		86.4		-0.3	
Female LFP	24.9		31.9		7.0		50.0		46.1		-3.9	
Difference (%)	**38.4**	**(100.0)**	**37.3**	**(100.0)**	**-1.0**	**(100.0)**	**36.7**	**(100.0)**	**40.3**	**(100.0)**	**3.6**	**(100.0)**
- Endowment (%)	*8.9*	*(23.3)*	*13.8*	*(37.1)*	*4.9*	*(-478.9)*	*6.4*	*(17.3)*	*8.6*	*(21.3)*	*2.2*	*(62.2)*
- Structural (%)	*29.4*	*(76.7)*	*23.5*	*(62.9)*	*-6.0*	*(578.9)*	*30.3*	*(82.7)*	*31.7*	*(78.7)*	*1.4*	*(37.8)*

Decomposition into *j-th* variables

	X's	Betas	X's	Betas	X's	Betas	X's	Betas	X's	Betas	X's	Betas
Total LFP Gap	**8.9**	**29.4**	**13.8**	**23.5**	**4.9**	**-6.0**	**6.4**	**30.3**	**8.6**	**31.7**	**2.2**	**1.4**
AGE	0.2	112.6	0.2	85.1	0.0	-27.5	-0.4	64.7	-0.5	63.9	-0.1	-0.8
CHILD	-0.1	6.2	-0.1	6.2	0.0	0.0	0.0	3.0	0.0	3.1	0.0	0.1
EDY	-0.6	-8.0	-0.1	-1.6	0.4	6.4	0.2	2.1	0.5	7.2	0.3	5.1
D	4.5	-0.3	8.4	0.7	3.8	1.0	2.6	-0.4	4.4	0.0	1.8	0.4
LHHDWAGE	0.7	2.5	1.3	0.9	0.6	-1.6	0.6	0.1	0.6	0.3	0.0	0.3
HHDEDY	4.1	-9.4	4.2	-9.7	0.1	-0.3	3.3	-3.3	3.6	-5.0	0.3	-1.7
REG1	0.0	2.4	0.0	1.3	0.0	-1.1	0.0	0.4	0.0	0.3	0.0	-0.2
REG2	0.0	1.0	0.0	0.5	0.0	-0.5	0.0	0.1	0.0	0.5	0.0	0.4
REG3	0.0	0.2	0.0	-0.3	0.0	-0.5	0.0	0.0	0.0	-0.1	0.0	0.0
REG4	0.0	-0.7	0.0	-0.8	0.0	-0.1	0.0	-1.0	0.0	-0.8	0.0	0.2
REG5	0.0	0.7	0.0	0.3	0.0	-0.3	0.0	-0.7	0.0	-0.9	0.0	-0.2
REG6	0.0	2.2	0.0	1.7	0.0	-0.5	0.0	-0.6	0.0	0.1	0.0	0.7
REG7	0.0	1.0	0.0	0.5	0.0	-0.5	0.0	-0.4	0.0	-0.3	0.0	0.0
REG8	0.0	0.7	0.0	0.1	0.0	-0.6	0.0	-0.5	0.0	0.1	0.0	0.6
REG9	0.0	0.8	0.0	0.3	0.0	-0.5	0.0	0.2	0.0	0.2	0.0	0.0
CONSTANT	0.0	-82.5	0.0	-61.8	0.0	20.7	0.0	-33.3	0.0	-36.8	0.0	-3.5

slightly during 1986-1997, as illustrated in Table 7. In 1986 male LFP was 63.2%, or 38.4% point higher than that of female. In 1997 men's LFP increased by 6% point to reach 69.2%, while that of women increased by only 7% point. As a result, the percentage of the female and male LFP gap decreased by only 1 point.

Table 7 also reveals that the difference in female and male endowment explains only the smaller portions of the narrowing LFP gap between in urban areas. Structural factors explain more of the phenomenon. While the difference in endow ment has been widening, the structural effect has been narrowing between 1986-97. In 1986, endowment effect can explain only 23% of the gap, but in 1997 it increases to 37%. The changes in structural effect are negative 6%, suggesting that the preference and constraint faced by women in labor market became smaller. In simpler words, we can say that this indicates that the urban labor market in 1997 is less discriminative compared with the situation in 1986.

Unlike that in the urban area, the female-male LFP gap in rural area has been widening during 1986-97. In 1986 male LFP is 86.6% while female LFP is 50%, resulting in 36.7% difference. During the period, male LFP has not been change much, while female LFP has declines considerably resulting in a widening gap from 36.7% to 40.3%. The decomposition analysis shown in the table reveals that both endowments as well as structural factors contribute to the increased LFP gap. However, the endowment effect is more dominant, accounting for 62.2% of the increase in the LFP gap.

The second part of Table 7 presents the contributions of each variable to the change in the LFP gap. There are some interesting findings. The *first* one is the effect of age. Apparently, the role of age in explaining the difference of individual endowments is positive, although not too significant. It means that at the same age, the average male productivity is slightly higher than female. But the role of age is much higher on the structural effects, suggesting that the structural barrier for female to enter the labor market is higher than for male in the same age group. However, the structural barrier is declining between 1986-1997, so the labor market becomes more gender neutral with respect to age. This situation applies to both urban (-27.5%) and rural areas (-0.8%). A more extreme case appears in rural areas where actually the market values the female labor productivity higher than male.

The *second* interesting finding is how the presence of dependent children accounts for the structural barriers for female to enter the labor market. While the market virtually gives relatively similar value to female and male productivity regardless the presence of dependent children, it is the structural factors that hold female from entering the labor market. Apart from the household division of labor hypothesis, this could be due to employer's perception that hiring female with children will ask for more day-off for family reasons.

The *third* is on the role of education. Clearly, in each year the education plays

role as an equalizer for the chance to enter the labor market in urban areas. This can be seen from the negative effect of education to the LFP gap in 1986 and 1997, both in the endowment and structural factors. However, the role of education as equalizer is diminishing in 1997, as the female education level become more and more similar to that of men, due to the rapid growth of women education between 1986-1997. Conversely, the role of education as equalizer does not happen in rural areas, where education contributes to the widening LFP gap in both endowment and structural factors. One possible explanation is that the rural labor market is characteristically more unskilled-labor oriented. Another interesting thing to notice is that most of the labor force are characteristically heads of household. *Fourth*, the household head dummy variable accounts for the widening LFP gap, and its contribution to the endowment effect is higher than to the structural effect. *Fifth*, income of the household head contributes to the narrowing urban LFP gap. This may suggest that the decision of urban female individuals to enter the labor market has become more similar to that of male, which are independent of non-earning income and of the education level of other family members. *Sixth*, the education of household head contributes to narrowing the LFP gap, in particular as it reduces the structural barriers for female household members to enter the labor market. This phenomenon applies to urban and rural areas.

CONCLUDING REMARKS

This study is undertaken to estimate the LFP equations that represent the determinants of LFPs for female and male individuals in Indonesia based on the Sakernas micro data. Based on the parameter estimates of the LFP equations, decomposition analysis is then conducted to measure the differential impacts of individual endowments and other factors on the LFP for female and male individuals.

During the period of economic liberalization, there is a tendency for female to stay longer in the labor market. The value of age in which the LFP reaches the peak was generally smaller for women in 1986 and 1990. But in 1997, the values of ages for women and men were similar, and therefore women seemed to stay longer in the labor force in recent years, and there was no significant difference between male and female LFP in this aspect.

Education plays a significant role in determining LFP, especially for urban female. There seems to be a general trend from the 1986-1990 data that the marginal effect of education of LFP was stronger for female rather than for male and for labor force in urban rather than in rural areas. But in 1997, the marginal effects of education on LFP are similar for male and female, even though the effect was still stronger in urban areas. One explanation for larger marginal effects of education in 1997 is the fact that education level was generally higher in 1997.

The estimated model confirms the "household division of labor" hypothesis. The probability for an individual female to enter the labor market decreases significantly when she is married or having more

dependent children in the family. On the contrary, being married and having more dependent children increases the probability of an individual male to enter the labor market.

The model also confirms the theory of individual LFP in which fixed income could increase reservation wage and therefore reduce the chance of taking a job offer. Higher fixed income -for example, the interest income or spouse's income- would certainly reduce the necessity and the chance of an individual participating in the labor market. When the individual is not a head of household, the impact of the education and earning (wage) of the head of the household on the LFP of household member is generally negative. In other words, higher education and larger income of the household head lead to smaller probability for other family members to enter the labor market. Education and income of household head are good proxy of fixed income, and the effects of those two variables on individual's decision in participating in the labor markets are negative.

Decomposition analysis based on the estimated LFP equation suggests that the urban labor market has been less discriminating against female. The evidence shows that the narrowing urban female-male LFP gap during 1986-19997 has been attributed to the decline in structural factors. Important structural factors that contributed to the closing were age, household head wage, and household head education. However, the closing of the gap due to the structural effects has been offset by almost equally widening LFP gap due to the endowment effects. Therefore, LFP gap between men and women in urban area has not been narrowing much during 1986-1997 periods.

In rural areas, however, the LFP gap has been widening during 1986-1997, as the male LFP has been relatively constant while the female LFP has declined considerably. Both endowment and structural factors contributed to the widening of the gap, but the role of endowment effects is greater. One reason is because the role of education as equaliser does not appear in rural areas, given the nature of rural labor market which is more unskilled-labor intensive.

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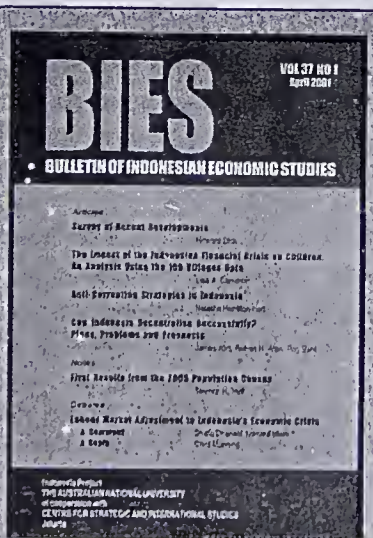
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Economic Aspects of Energy Resources and Its Implication for Sustainable Development

Armida S. Alisjahbana[1]

ENERGY RESOURCES[2]

Reserves and Production of Oil Resources

INDONESIA currently holds proven oil reserves of 5 billion barrel, representing 0.47% of total world reserves. For the last 15 years, after extraction of around 30 million barrel a year, the data from Ministry of Mining and Energy shows that Indonesian oil reserves have not changed significantly. In 1980, Indonesian proven reserves were around 4 billion-barrel and when combined with potential reserves following new exploration and discoveries, there was an increase from 5.5 billion barrels in 1980 to around 9 billion barrels in 1997. Its share in total world reserves, however, had dropped from 1.6% in 1978 (rank 13th) to 0.5% in 1998 (rank 22nd).

Most of Indonesia's producing oil fields are located in the central and western sections of the region. Indonesia's largest oil producing province is Riau where the large Duri and Minas oil fields are located. Other important oil fields are located offshore. Northwestern Java, East Kalimantan, and the Natuna Sea.

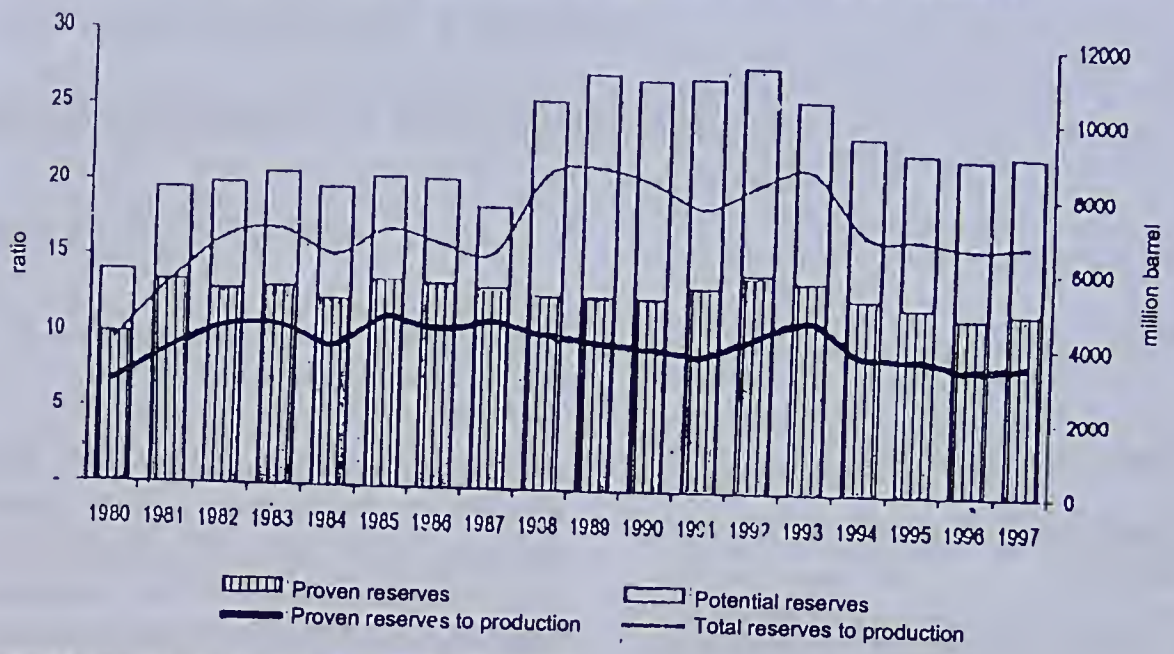
Ratio of reserves to current production is widely used as indicator of future availability of natural resources. From this indicator, based on proven reserves, Indonesian current rate of oil extraction will last for only 9 years, while based on total reserves (proven and potential reserves), the current rate of production will be maintained within the next 17 years. This indicator, however, should be observed more carefully, since historical data on this ratio seems to be relatively stable. These observation indicated that the rate of oil production discovery seems to be accompanied by the same rate of new discovery resulting in relatively stable ratio of proven reserves to current production during the 1980 to 1997 period (see the following Figure).

[1]The author would like to thank Wawan Hermawan of Faculty of Economics, Parahyangan University for the helpful research assistance he provided.

[2]Based on Alisjahbana and Yusuf (2001). Energy resources in this sub-section discussion refer only to three major energy sources namely: oil, gas and coal.

Figure 1

OIL RESERVES AND RESERVES TO PRODUCTION RATIO 1980-1997



Source: Dirjen Migas, Ministry of Mining and Energy

Since late 1980s to date, Indonesian oil production relatively remain stable at around 1.5 million barrel a day or around 500 million-barrel annually. Despite its slight decline in oil proven reserves since 1993, Indonesia could still maintain its rate of extraction among others by introduction of crude streams from new, smaller fields that helped compensate for declines at many of the country's mature oil fields.

Most of Indonesian crude oil extraction was supplied to the world market. It could be seen from demand components of crude oil sector output. More than half of the output was exported, i.e., 61% in 1990 and 53% in 1995. Domestic industry only absorbed around 1/4 of the total output. Domestic petroleum refineries in 1995 only demanded 6 trillion Rupiah of oil sector output totaled 22 trillion Rupiah.

Natural Gas Reserves and Production

At the end of the year 1998 Indonesia hold proven natural gas reserves of 72.3 trillion cubic feet. This made Indonesia one of the 13 biggest holders of natural gas reserves or 1.4% of world reserves totaling 4,170 trillion cubic feet. This could be considered an improvement since in 1978 Indonesia only hold 0.96% of total world reserves (ranked 18th). Indonesia's main gas reserves are located near the Arun field in North Sumatra, around the Badak field in East Kalimantan, in smaller fields offshore Java, the Kangean Block offshore East Java, a number of blocks in Irian Jaya, and the Natuna D-Alpha field, the largest in Southeast Asia.

The development of gas exploration and discovery since the late 1970s could

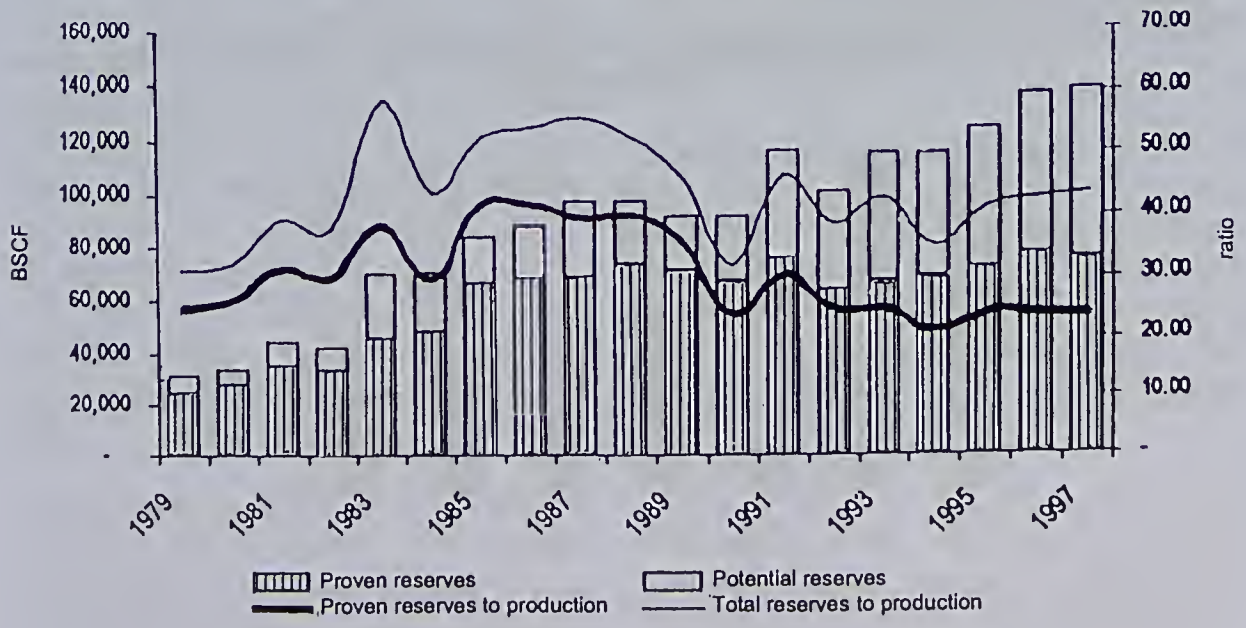
be observed in Figurre 2 below. The result of active exploration made the trend of proven gas reserves increase from 25 trillion cubic feet in 1979 to 76 trillion cubic feet in 1997. This was started among others by large discovery of natural gas reserves in 1971 at Arun field, Sumatra by Mobil Oil and Badak fileld, Kalimantan in 1972 by Huffco.

Based on proven reserves to production ratio, Indonesia's current rate of production could be maintained within the next 30 years. If combined with potential reserves, based on 1997 rate of production, this could be extended to the next 43 years. Assuming all potential reserves could be economically exploited, Indonesia then, will still have enough reserves to produce natural gas up to 2040 with current rate of exploitation.

From the data it is clear that the trend of gas production increase significantly from early 1970s to late 1990s. Most of natural gas was exploited by production sharing contract companies. Currently, according to data from British Petroleum Company, Indonesia supply 3% of total world natural gas production or around 63 out of 2272 billion cubic meters. For the last decades, the rapid increase in Indonesian gas production has resulted in its larger share in world production. In 1988, Indonesian gas production ranked 8th; and at the end of 1998 it became one of the world's 6 largest producers as well as the largest natural gas producer in Asia.

Figure 2

NATURAL GAS RESERVES AND RESERVES TO PRODUCTION RATIO 1979-1997
(Billion Standard Cubic Feet)



Source: Dirjen Migas, Ministry of Mining and Energy

The increase in natural gas production was accompanied by the development of natural gas utilization in the form of LNG refineries, fertilizer, steel, as well as city gas. Based on data from Input-Output Table, all of natural gas production was domestically absorbed mainly to LNG refinery. However the share of LNG refinery was observed to significantly dropped from 89% in 1990 to about 60% in 1995. This was caused by the increase in demand from electricity and gas sectors for natural gas for other use, such as petroleum refinery, fertilizer and other use.

Exports of LNG from Arun (Sumatra) and Bontang (Kalimantan) to Japan began in 1977-1978. Indonesia has for many years been the world's leading exporter of LNG. Shipments in 1996 were chiefly to Japan (70%) but also to the Korean Republic (24%) and Taiwan-China (6%).

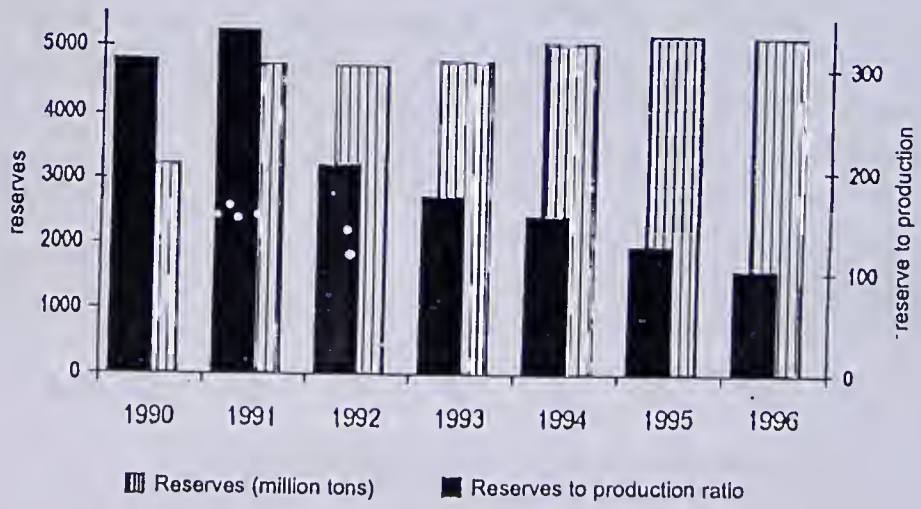
Coal Reserves and Production

Among other mineral resources, Indonesia is very rich in terms of coal reserves. Recently Indonesian coal reserves amounted to 5,220 million tons or 0.53% of total world reserves. This high amount of reserves makes Indonesia rank 5th among the world's coal producers. Around 2/3 of Indonesian coal reserves are located in Sumatra and nearly 1/3 in Kalimantan. Although Kalimantan contains lower proportion of coal reserves, its quality is better than that of the Sumatra coal. Based on current data on reserves to production ratio and assuming no new discovery, Indonesia could maintain its present rate of extraction for the next 87 years.

Energy crisis in 1974-1975 was widely considered as the impetus to the growth of coal production. Another important development was government policy in

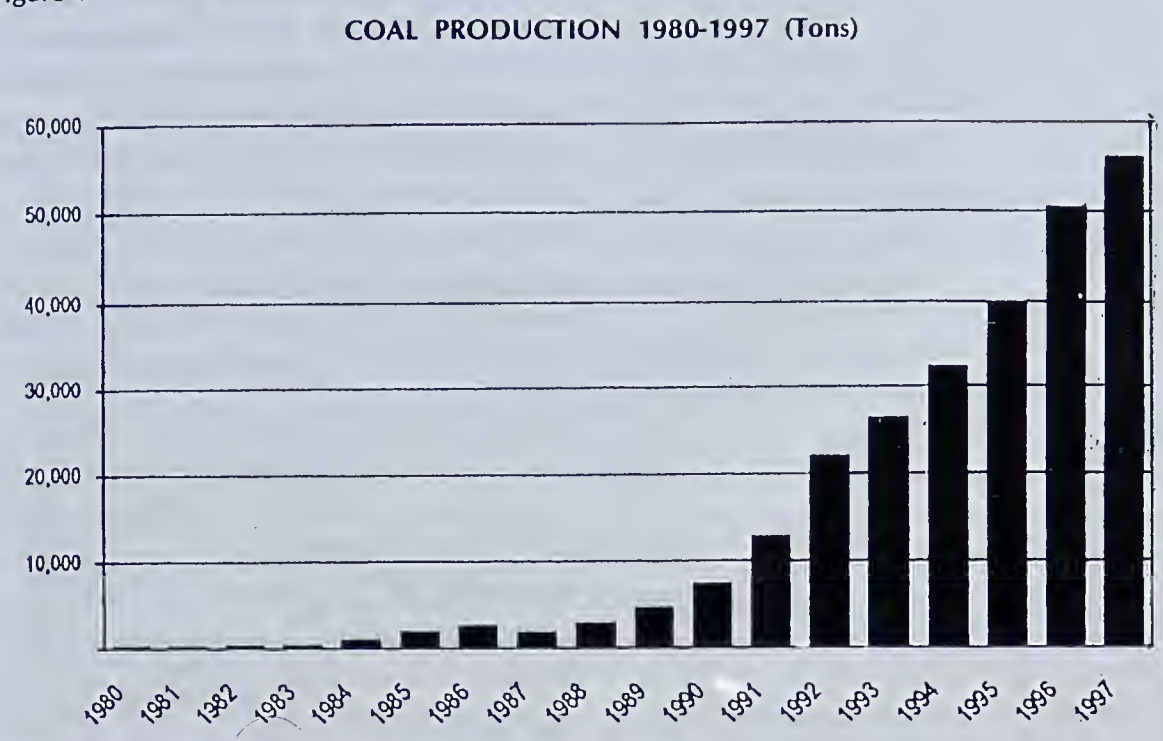
Figure 3

COAL RESERVES AND RESERVES TO PRODUCTION RATIO 1990-1996
(Million Tons)



Source: BPS, *System of Integrated Environmental and Economic Accounting.*

Figure 4



Source: BPS, *Non-migas Mining Statistics*, various years.

the framework of *national energy policy* in 1976 that encouraged more energy substitution to make economy less dependent on oil and gas. This development, among others, could be the trigger of the rapid increase of coal production in the late 1970s and early 1980s. As can be seen from Figure 4 since early 1980s the growth of coal production has been increasing. At the late 1980s and 1990s, furthermore, the trend has been accelerating. During less than two decades Indonesia's coal production was observed to be 100 times higher.

The increasing trend of production in 1990s is shown in Figure 3 where reserves to production ratio were decreasing due to enormous increase in coal extraction during the period. At the end of 1998, Indonesia supplied around 1.7% of total world production. In 1988, Indonesia's share in total world production was only 0.11%, but ten years later it has become 15 times higher.

ENERGY CONSUMPTION[3]

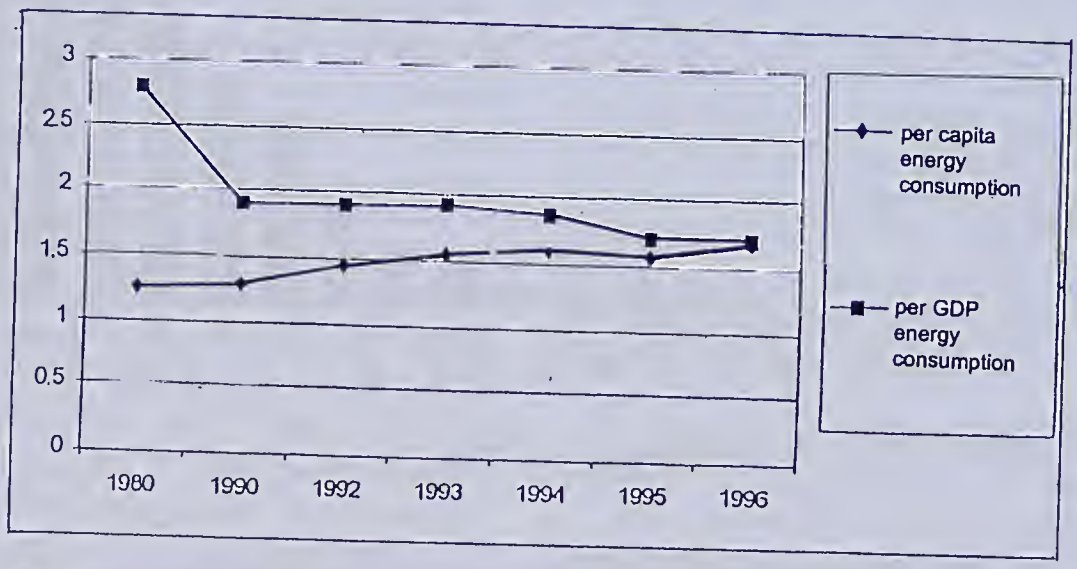
Indonesia is the fifth largest consumer of energy in East Asia after China, Japan, India, and South Korea. The total energy consumption increased threefold over the past two decades, from approximately

[3]The discussion on this section draws entirely on Resosudarmo, et.al., "Energy Resources", report presented to United Nations University/Institute for Advanced Studies under Sustainable Development Project for Indonesia, 2001, and Resosudarmo and Alisjahbana, forthcoming.

184 million Barrel of Oil Equivalent (BOE) in 1980 to approximately 595 million BOE in 1998 (EIA: International Energy data base 1999). This increase was relatively faster than the increase in Indonesian population, but slower than the increase in GDP. Hence, while per capita energy consumption increased, per GDP energy consumption decreased in the last two decades. Figure 5 shows that per

Figure 5

PER CAPITA AND PER GDP ENERGY CONSUMPTION



Source: WEC, *National Energy Data Indonesia* (1999) as in Resosudarmo (2001).

Table 1

ENERGY CONSUMPTION BY SECTORS IN 1997/1998
(in Million BOE)

(in million BOE)	Industrial		Household		Transportation		Total	
Petroleum-based fuel	**67.7318** 47.85%	23.66%	**62.7829** 70.24%	21.93%	**155.7561** 100%	54.41%	**286.2708** 74%	100%
Natural gas	**36.3401** 25.67%	99.39%	**0.0628** 0.07%	0.17%	**0.1586** 0%	0.43%	**36.5615** 9%	100%
Coal	**16.74969** 11.83%	100%	**0** 0%	0%	**0** 0%	0%	**16.74969** 4%	100%
LPG	**2.0081** 1.42%	27.87%	**5.1888** 6%	72.01%	**0.0088** 0%	0.12%	**7.2057** 2%	100%
Electricity	**18.72546** 13.23%	46.72%	**21.35157** 23.89%	53.28%	**0** 0%	0%	**40.07703** 10%	100%
Total	**141.56** 100%	36.59%	**89.39** 100%	23.11%	**155.92** 100%	40.30%	**386.8647** 100%	100%

Source: Ministry of Mines and Energy, 1999 as in Resosudarmo, et.al. (2001).

capita energy consumption increased from approximately 1.25 BOE per capita in 1980 to approximately 1.68 BOE per capita in 1996 while per GDP energy consumption decreased from approximately 2.78 BOE per thousand 1990 USD to approximately 1.7 BOE per thousand 1990 USD (WEC, 1999). This fact indicates that the Indonesian economy has consumed energy more efficiently.

Among the energy consumed by final demand, the most consumed one is petroleum-based fuel. Indonesian Ministry of Mining and Energy (1999) noted that, in the fiscal year 1997/1998, approximately 74% of total energy consumption is petroleum-based fuel. Electricity is placed second (10% of total energy consumption),[4] followed by natural gas and coal ranking the third and fourth, respectively (Table 1).

Interesting to observe is the consumption of petroleum-based fuel. During the end of 1960s to the beginning of 1980s, household sector was the largest consumer of petroleum-based fuel. However, since 1984, transportation sector became the largest consumer.

All nominal prices of various petroleum-based fuel were mounting in the last two decades (see Figure 6). Thus, the increase in petroleum-based fuel consumption by the transportation sector was most likely caused by the significant increase in the number of vehicles in Indonesia.

For electricity in 1997/1998, the major consumer is household sector (see Table 1). Households consumed approximately 53% of the total electricity produced. In the last ten years, the consumption has increased tenfold from approximately 5 million BOE in 1989/1990 to approximately 40 million BOE in 1997/1998.

Most of the electricity is generated using petroleum-based fuel electric generation. The role of renewable energy in generating electricity is still trivial. In 1998, the amount of electricity generated using hydropower was only 0.09% of the total electricity generated while the sum of electricity generated by geothermal, solar, biomass, wind, and tidal wave only counted for 0.04% of the total electricity generated (EIA, 1999).

Natural gas is mostly consumed by the industrial sector (approximately 99%), particularly the fertilizer industry (39%) and the national electric company (39%). From 1979/1980 to 1997/1998, natural gas consumption increased by more than threefold, from approximately 10 million BOE to approximately 36 million BOE.

From the consumer side, the Indonesian Department of Mining and Energy (1999) claimed that the transportation sector was the largest consumer of energy. In 1997/1998, it consumed approximately

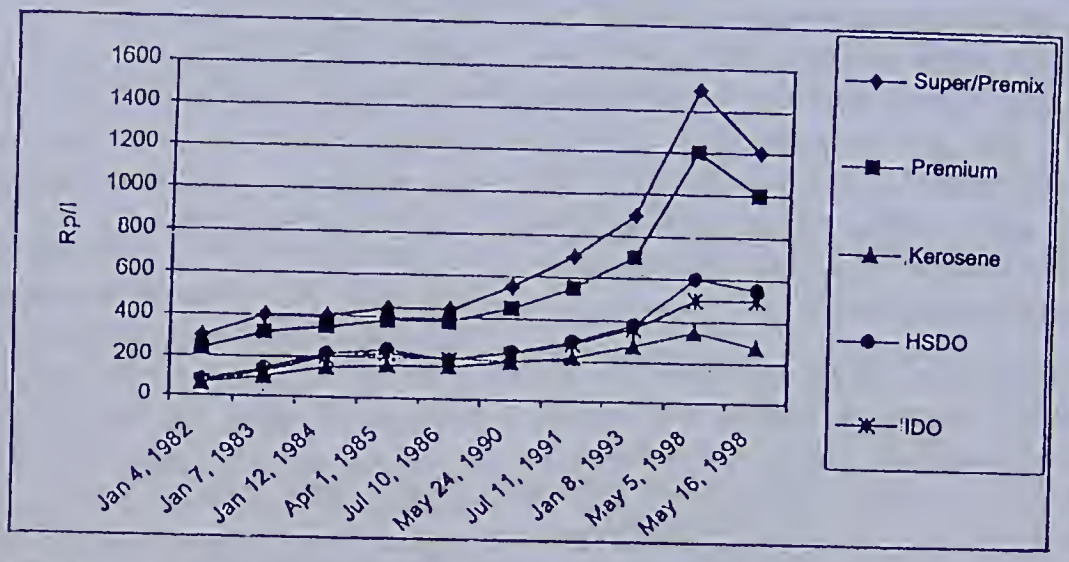
[4]Energy demand should be defined as follows:

(a) Energy consumed by final demand or final energy consumption/demand: Types of energy that are consumed directly by final demands, i.e. petroleum-based fuel, natural gas, coal, electricity, and LPG.

(b) Demand/consumption of energy source or primary energy consumption/demand: Types of extracted natural resources that become the sources of energy, i.e. crude oil (oil), natural gas, coal, and renewable resources (mostly hydropower).

Figure 6

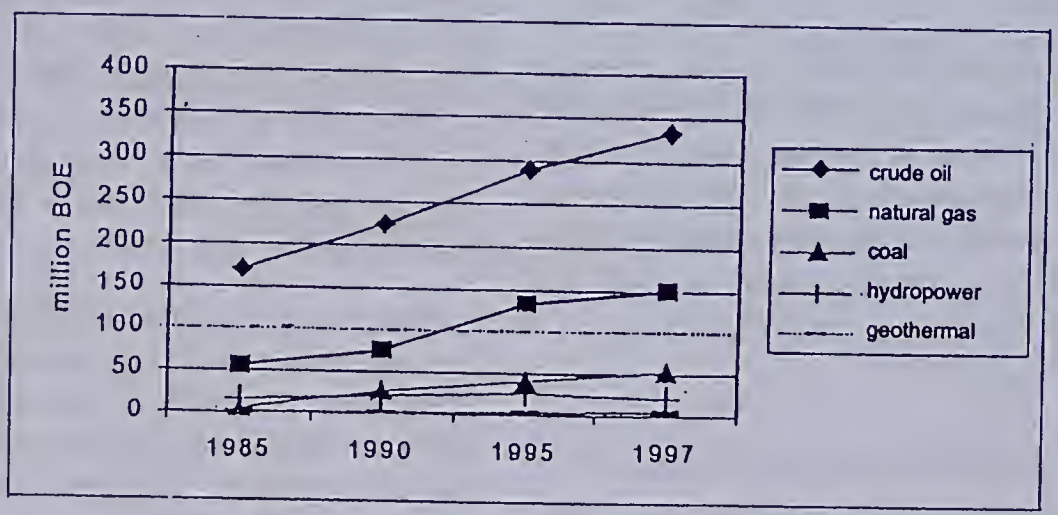
PETROLEUM-BASED FUEL PRICES IN INDONESIA (in Rupiah/liter)



Source: CES-UI, 2000 as in Resosudarmo et.al. (2001).

Figure 7

TREND OF ENERGY SOURCES



Source: Ministry of Mines and Energy, 1999 as in Resosudarmo et.al. (2001).

40% of the total energy consumption. All of this energy consumption came from petroleum-based fuel. Industrial sector was the second largest consumer of energy. It consumed approximately 37% of the total energy in 1997/1998. Approximately 48% of total energy consumed by the industrial sector was petroleum-based fuel, and approximately 27% was natural gas (Table 1).

Figure 7 presents the trend of energy sources in Indonesia. It can be seen that hydropower and geothermal have contributed small and relatively stable shares. On the other hand, the shares of crude oil and natural gas have increased steadily. By comparing fossil fuels and the renewable energy resources, one can conclude that the latter has not yet been developed as major energy resources. The contribution of renewable energy resources to the development of the Indonesian economy is insignificant at the present time.

ENERGY RESOURCES AND THE ECONOMY

Contribution to GDP

The effect of the economic crisis which occurred in mid-1997 has resulted in a severe contraction of the 1998 GDP of 14%. GDP has started to grow again slowly since 1999, when it grew at a rate of 0.31%. The economic crisis was simultaneously accompanied by sharp depreciation of the Rupiah against most major foreign currencies. Its effect has been felt mostly in terms of increased inflationary pressures especially of imported goods. However, for exported goods its value in terms of nominal Rupiah has increased significantly.

The economic crisis with its ensuing sharp depreciation of Rupiah has reflected itself in oil, gas and electricity sector contributions to GDP. While the production amount has been more or less stable, its respective share to GDP in 1998 had increased both for oil, gas industry and the mining sector. At the peak of the economic crisis in 1998, the share of oil, gas and electricity sector contribution to GDP reached its peak of 14% compared with the previous share of 12% (see Table 2).

However, if we look at the decomposition among each sectoral contribution, there appears to be a slight shift away from the minerals sector to the oil and gas sector (both industry and mining sector). This temporary development is due to two factors: *First*, the contraction in GDP while at the same there was an increase in gas and oil revenues in Rupiah terms because of the sharp Rp depreciation. *Second*, it is temporary because if we look at the 1999 data, there was a slight drop in oil, gas, mining and electricity contribution to GDP reversing the previous year trend.

On average during the 1996-1999 period, it can be assumed that the energy sector as a whole contributes between 11 to 14% of GDP. Majority of the share comes from mining sector, i.e. oil and gas.

As Source of Government Revenues

The largest portion of energy sector contribution to government revenues is derived from oil and gas sector. Government revenues from oil and gas sector are influenced by three factors: international oil price, oil and gas sector production, and the exchange rate.

The international oil price has been on the increasing trend since 1998/1999 when it was only US$11.95 per barrel. During fiscal year 1999/2000, it has risen to US$19.92 per barrel, about 90% higher than the oil price assumption on the budget. The sharp increase in oil price at that time

was largely due to oil production cut among OPEC members and decrease in world oil reserves.

Oil prices have been fluctuating since 1999/2000. During fiscal year 2000, it averages at US$27-28 per barrel much higher than its budget assumption. At the other end, production has been steady at about 1.4 million barrel per day.

The development of Rupiah exchange rate since the crisis can be summarized as follows. Average exchange rate during fiscal year 1998/1999 it was Rp 9,768/US$, in 1999/2000 it averaged Rp 7,479/US$, and in 2000 it even reached Rp 9,105/US$ at one point. With given production rate and Rupiah exhange rate, oil and gas revenues reached Rp 38 trillion in 1999/2000.

Government revenues from gas sector depend to a large extent on oil price movement, and gas production. Major gas markets are Japan, Korea and Taiwan. Government revenues from gas sector was Rp 15.410 trillion and Rp 20.457 trillion in 1999/2000. Further investment in the gas sector has been sought from private investors.

Fuel Subsidy

Tables 3 below shows the dynamics of fuel price changes in fiscal year 2000 and 2001, its economic value and its subsidized value in Rp per liter. Table 4 shows

Table 2

OIL, GAS AND ELECTRICITY SECTOR CONTRIBUTION TO GDP (Billion Rp) IN 1993 CONSTANT PRICES

GDP by Sector	1996	1997	1998	1999
GDP	413,798.0	433,246.1	376,892.8	393,200.6
Oil and gas industry	10,863.9	10,650.3	11,042.3	11,700.0
Oil refinery	6,291.5	5,925.5	6,310.0	6,630.0
Liquid gas	4,572.4	4,724.8	4,732.3	5,030.0
Mining sector	37,739.3	38,538.2	37,473.0	36,820.0
Oil and gas	24,062.8	23,919.8	23,340.1	22,140.0
Mining excluding oil and gas	7,267.6	7,645.6	9,678.0	10,310.0
Minerals	6,408.9	6,972.8	4,454.9	4,370.0
Electricity	3,983.0	4,463.3	4,584.8	4,980.0
Percentage to GDP				
Oil and gas industry	2.63%	2.46%	2.93%	2.37%
Oil refinery	1.52%	1.37%	1.67%	1.34%
Liquid gas	1.10%	1.09%	1.26%	1.02%
Mining sector	9.12%	8.90%	9.94%	7.45%
Oil and gas	5.82%	5.52%	6.19%	4.48%
Mining excluding oil and gas	1.76%	1.76%	2.57%	2.08%
Minerals	1.55%	1.61%	1.18%	0.88%
Electricity	0.96%	1.03%	1.22%	1.01%

Source: CBS and Ministry of Cooperatives.

Table 3

FUEL PRICES, ECONOMIC VALUE AND SUBSIDIZED VALUE IN 2000

Fuel type	Rp/liter		Economic	Subsidized value Rp/liter	
	Old price	New price	Value Rp/liter	Old price	New price
Premium	1,000	1,150	1,756	756	606
Kerosene	280	350	1,696	1,416	1,346
Diesel	550	600	1,826	1,276	1,226
Diesel oil	500	550	1,771	1,271	1,221

Table 4

FUEL PRICES IN 2001

Fuel type	Market price (Rp/liter)	50% Market price (Rp/liter)	International bunker price
Premium	1,760	1,450	
Kerosene	2,140	1,070	
Diesel	2,000	1,000	21.80 cents/liter
Diesel oil	1,950	975	21.20 cents/liter

Table 5

FUEL SUBSIDY IN APBN 1998/1999, 1999/2000 AND 2000 (Billion Rp)

Description	1998/1999		1999/2000		2000	
		% GDP		% GDP		% GDP
Subsidy (total)	35,785.7	3.4	60,767.9	5.3	51,143.8	5.4
Fuel subsidy	28,606.6	2.7	40,923.1	3.6	41,314.0	4.4
Non-fuel subsidy	7,179.1	0.7	19,844.8	1.7	9,829.8	1.0
Total APBN	111,526.8	11.2	167,560.4	14.7	174,918.2	18.5

Source: RAPBN 2001.

the new fuel price adjustment in fiscal year 2001.

Fuel price subsidy has become major expenditure item in the budget, rapidly increasing during the past three budget years (Table 5). It is estimated to cost more than a quarter of the total budget in fiscal year 2000. Fuel price subsidy involves complicated issues of cross subsidy among different types of consumers, incentives/disincentives to fuel consumption conservation, and burden on government budget.

FINAL REMARKS: CHALLENGES AND PROBLEMS[5]

In general, there are three main challenges with regard to the expected rapid growth of energy demand: (1) finding enough funds to develop new energy production facilities; (2) finding new resources and managing currently available natural

[5]Part of the discussion in this section follows that in Resosudarmo, et.al. (2001) and Resosudarmo and Alisjahbana (forthcoming).

resources as energy sources; and, (3) managing emissions from the use of energy.

Development of new energy resources and its supply infrastructure is currently very costly for the country, particularly since Indonesia has yet to completely revive from its economic crisis. Historically, development of energy supply infrastructures was highly dependent on foreign financing. The increasing scarcity of available foreign financing for the country will definitely affect the addition of supply capacity, at least in the near future, noting that the energy sector is highly technology intensive and capital intensive.

Proper management of natural resources as energy sources is another challenge that has to be faced. Indonesia highly depends on crude oil as the energy sources for the country. Furthermore, it is expected that in around 2014 crude oil import will be higher than the domestic production. Decreasing export of crude oil will generate a reduction in foreign income, and the growing import will also increase the dependence on foreign supply; thus adding the burden to energy supply security. Clearly, Indonesia needs to diversify its energy resources. An option to choose is to intensify the development of renewable resources. As mentioned previously, the role of renewable resource, such as hydropower, solar, and ocean thermal energy conversion, is very low. As a maritime country located at the equator, Indonesia certainly has abundant possibilities to develop water and solar energy resources.

Another problem with crude oil, and actually all fossil fuels, as energy resources, is their emitted pollution. The combustion of fossil fuels produces gas emissions, such as, CO_2, NO_2, SO_2, and CH_4. These gas emissions, which are often referred to as greenhouse gas emissions, generate global warming and are also dangerous to human health. Fossil fuels supplied approximately 93%-95% of total primary energy consumption for the past fifteen years and the trend is upward sloping.

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THE INDONESIAN NATIONHOOD AND CHALLENGES OF GLOBALIZATION

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On 5 September 2001, CSIS had celebrated its 30th anniversary with a seminar on "the Indonesian Nationhood Revisited." Such a topic was raised as it was realized that Indonesians needed to redefine its nationhood while taking into account the new global realities as well as aspirations at home. To this end, some considerations with regard to long-term goals and ideas are required.

This publication contains papers contributed by members of the CSIS Board of Trustees and CSIS International Advisory Board that were presented at that seminar. Some of the papers included in this publication respectively discuss issues on reinventing the Indonesian Nationhood, challenges to the Nation-State, and challenges of globalization for the Indonesian economy.

The publication of those papers is mainly aimed at sharing thoughts and ideas presented at that seminar to a wider audience, in particular to those who are interested in the study of Indonesia and its regional cooperation amidst the ASEAN community.

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Political Islam and the Use of Societal Approach in Indonesia's Foreign Policy

Anak Agung Banyu Perwita

INTRODUCTION

THE past few years have seen world politics undergoing rapid and dramatic changes since the end of the Cold War era. Those changes have accordingly posed a tremendous challenge for most, if not all, nation-states in managing their political affairs at both domestic and international levels. At this point, the role and the task of the Ministry of Foreign Affairs (*Departemen Luar Negeri/Deplu*) in managing Indonesia's foreign relations are becoming more crucial and more complicated as it sometimes has to deal with problems beyond its normal sphere of competence.

During the Soeharto era -as MacIntyre argued- the policy making was very heavily 'state-centred'. As a result, the possibility for 'extra-state actors' (society, for example) to play a major role in (foreign) policy formulation was very limited.[1] This was caused by two main strategies applied by the Soeharto's regime. First is the *inclusionary strategy*, which was aimed to co-opt the larger society into conditional participation in domestic political process which in principally controlled by the State. Second is the *exclusionary strategy* that seeks to mitigate or even deny society influencing in the wider political community through repression.

This article attempts to delineate an alternative approach in Indonesia's foreign policy in response to the new challenges that Indonesia, particularly the Ministry of Foreign Affairs, has to face.

COMPETING APPROACHES IN FOREIGN POLICY

Just as it is in the domestic arena, the societal factor[2] is one of crucial elements in

[1] Simon Philpott, *Rethinking Indonesia: Postcolonial Theory, Authoritarianism and Identity* (London: McMillan Pres, 2000), 71.

[2] Societal factor in foreign policy analysis includes culture, history, and social structure. Other theorists of foreign policy, such as Patrick MacGowan and Howard Shapiro noted it also includes political culture and ideology and belief system. In reality, it consists of elements in domestic communities which have interests with the making of foreign policy.

foreign policy making and behaviour. Consequently, at the domestic level[3] this factor has frequently motivated and influenced the ruling elites (the policy makers) in managing foreign policy and external relations of states. However, its exact impact on foreign policy cannot be easily determined, since in many cases it is simply considered as one single factor that is not too important. The impact of societal factor on the country's foreign relations will often matter only when other factors, such as geopolitical and geostrategic considerations, economic needs, and regime's interests, are involved.

The current internal and international conditions have, to a large extent, necessitated the government to comprehensively deal with problems that are sensitive to both domestic and international criticism. The emergence of new issues -such as, democratization, drugs trade, environment, human rights, labor, human trafficking, and terrorism- in post-Cold War world politics demands a new alternative approach from the government.

Obviously, the above issues cannot be handled by the Ministry of Foreign Affairs alone. In this case, the need to strive toward a comprehensive foreign policy will not only involve other ministries but also invite larger elements of Indonesian society. Greater public participation in the formulation of our foreign policy also needs to be intensified. In other words, the state-society relations will eventually affect the effectiveness of Indonesian foreign policy.

There are at least three possible approaches to state-society relations in foreign policy analysis, which might be relevant to our foreign policy.[4] The first model is "Statist", which closely corresponds to Realist theory. This approach assumes that "state decision makers formulate foreign policy largely autonomously of societal influences."[5] To put it simply, the state is assumed to be much stronger than the society, thereby making the role and the influence of society in foreign policy neglected. This model argues that states have full authority (institutional autonomy[6]) in managing their foreign relationships and tend to neglect the role of societal in foreign policy making. In this context, the state demonstrates its role as 'domestic agential power' or 'the state's ability to shape domestic realm and construct foreign policy relatively free of domestic social structural constraints.'[7]

[3]The domestic level consists of the society, the political process, the goals, motives and priorities of state leaders and when and under what conditions the societal groups are most likely to exercise it. For further elaboration on this matter. See David Skidmore and Valerie M.Hudson, "Establishing the limits of state autonomy: contending approaches to the study of state-society relations and foreign policy making," in David Skidmore and Valerie M.Hudson, eds., *The Limits of State Autonomy: Societal Groups and Foreign Policy Formulation* (Colorado: Westview Press, 1993), 6.

[4]Skidmore and Hudson, eds., *The Limits of ...*, 20-21.

[5]Ibid.

[6]This concept refers to Theda Skcopol's. See, John M.Hobson, "The 'Second Debate' in International Relations: Theory Turned Upside-Down," in *Review of International Studies* 27 (2001): 395-414.

[7]Ibid.

The second is the "Societal approach". In contrast to the first approach, "Societal approach" assumes that societal groups within state play a dominant and continuing role in foreign policy. This approach consists of two models: (1) The pluralist model; and, (2) Social Blocs model. The pluralist model is based on the assumption that "political leaders care most about maintaining a high level of domestic political support", which is "a prerequisite both for maintaining and for maximizing"[8] their influence on and effectiveness of foreign policy decisions. The latter model involves "a variety of alternatives to pluralism, including elite, Marxist, corporatist and sectoral blocs" of society.[9] This approach emphasizes the role of mass media, non-government organizations, and other groups in society as pressure groups in controlling and even directing the issues and contents of foreign policy making.

The third is "the Trans-national approach" which emphasizes the existence of a global society. This approach assumes that "societal groups with similar interests (or even common interests) and objectives will form political coalitions which surpasses national boundaries."[10] These networks of cooperation, then, provide issues, which foreign policy actors should take into account in foreign policy formulation. The goals of trans-national society may vary from transformations of particular regimes (to battle authoritarian regime), mediating and settling international conflict (Arab-Israeli conflict), putting new issues in the global agenda (environmental issue), and changing global values, standards and norms (democratization and human rights).

Theoretically, the interactions and linkages between domestic and external environments may generate three major types of linkages[11]: (1) the "penetrative"; (2) the "reactive"; and, (3) the "emulative". Furthermore, it may also produce two types of domestic political objectives[12] namely: building political coalitions and retaining political power. The first objective assumes that foreign policy decision makers "need to build domestic support for any proposed policy initiative."[13] Building political coalitions played a very important role in many Third World foreign policies, since the interaction between domestic support and foreign policy making is a primary value in domestic political standing.

[8]Skidmore and Hudson, eds., *The Limits of ...*, 10.

[9]Ibid.

[10]Ibid, 14.

[11]The "penetrative linkage" refers to the direct participation or influence of the external and domestic environment in the foreign policy decision-making process of a country. The "reactive linkage" is caused by boundary crossing without direct participation made within the unit (state). While the "emulative linkage" is a foreign policy response similar to the action that triggers it. See, James N. Rosenau, ed, *Linkage Politics* (New York: Free Press, 1969), 44.

[12]Laura Neack, Jeanne A.K. Hey, and Patrick. J. Haney, *Foreign Policy Analysis: Continuity and Change in Its Second Generation* (New Jersey: Prentice Hall, 1995), 122-127.

[13]Skidmore and Hudson, eds., *The Limits of ...*, 124.

This is mainly due to the fact that "many Third World governments are very institutionally complex" and the political regime is "dominated by a single predominant leader but are actually racked by political infighting among contending factions."[14] Thus, foreign policy decisions become "political resultants", which reflect "the political strategies necessary to build agreement" with the domestic structure "to support implementation of policy."[15]

The second domestic political objective assumes that foreign policy decision "should be adjusted so that it imposes fewer domestic costs."[16] This is because "retaining political power" is in particular based upon "the value of holding the leadership position."[17] So in order to stay in the office, a national leader -who faces a significant domestic opposition from the wider domestic structure- needs to raise public perception of foreign policy issues. In many Third World foreign policies, retaining political power is a more dominant theme than coalition building. Yet many Third World countries might always be able to impose rational foreign policy initiatives without worrying about the political opposition from the domestic political society.

POLITICAL ISLAM[18] AND IN DONESIA'S FOREIGN POLICY

The inclusion of public participation in the foreign policy formulation is mainly aimed to support the government in its implementation. Indeed, society's growing demands for being involved in particular foreign policy issues will, under certain circumstances, affect the foreign policy behavior. This is because the state's conduct of foreign policy is a function of its current internal political dynamics.

The recent massive reactions of some elements of Indonesian Muslim society towards the war in Afghanistan and the wave of anti-Western (the U.S.) mass demonstrations were clear examples of people's strong willingness to participate in Indonesia's foreign policy. Clearly, the government is very concerned that the war in Afghanistan could increase domestic support for Islam radical groups, such as *Front Pembela Islam* (Islamic Defender Front), *Laskar Jihad* (Jihad Troops).[19] However, the response of some Indonesian Muslim society was inconsistent when the U.N. informally requested Indonesia to join the peacekeeping forces in Afghanistan. They even refused the plan by arguing that Indonesia's participation will only be

[14]Neack, Hey, and Haney, *Foreign Policy Analysis* ..., 124.

[15]Ibid., 122.

[16]Ibid, 124.

[17]See, Douglas Van Belle, "Domestic Imperatives and Rational Models of Foreign Policy Decision Making..," in Skidmore and Hudson, *The Limits of*..., 154.

[18]As Azra points out, the rise of political Islam is "the most visible political developments in the era of post-Soeharto Indonesia. See his article "The Challenge of Political Islam to Megawati," in *The Jakarta Post*, 22 November 2001.

[19]International Crisis Group, "Indonesia: Violence and Radical Muslims," Indonesia Briefing: Jakarta/Brussel, 10 October 2001, 11-14.

used as "a buffer for the US in dealing with the people in Afghanistan."[20]

The Indonesian Muslim community's demands for greater participation in foreign policy making can be clearly seen as 'the desire for recognition' of the Muslim voice in Indonesia's foreign policy which it perceived as part of significant 'public sphere' in state-society relationship. Eventhough most efforts of Islamic revival have initially directed to Muslim societies, its effects have colored and even complicated some issues of international affairs.[21] According to Azra, the revival of political Islam may continue to affect the course of Indonesian politics as a whole, including foreign policy.[22]

The wake of Islamist movements initially emerged amidst the increased social-political crises in the Muslim world. They existed particularly as a societal phenomenon. Yet, the rise of these movements may be attributed to the politics of globalization.[23] In Holton's view, the revival of political Islam in many Muslim countries could be interpreted either as "a deglobalizing trends towards localism and regionalism", or as "a reglobalizing movement challenging the credentials of Western approaches to globalization."[24] In other words, the political Islam in this respect is simultaneously global, regional, national, and locally specified.

The growing militancy and power of the Islamic political pressures from the Muslim community have accordingly put the government in a huge policy dilemma. Moreover, they will also compel the government/ state to 'accommodate' their wishes in the policy making process. Hence, the government will obviously be faced with more political risks from domestic radical Islamic opposition if it, for instance, cooperates too closely with the US on the issues related to political Islam.

Nevertheless, the role of Muslim community in foreign policy issues largely depends on the condition of domestic politics. Many fragmented and fractious Islamic groups could possibly provide the basis of 'moderate' foreign policies for the government. It is a common phenomenon in many developing countries that the governments can easily exploit the links between their domestic political stability and that of the states to increase their leverage over domestic politics. Such an assumption is mainly based on the fact that the governments have their own political needs and agendas and seek to maintain them in the name of domestic political stability and security.

[20]Bantarto Bandoro, 'Indonesia Must Join Afghan Mission," in *The Jakarta Post*, 21 October 2001.

[21]James Piscatori, "Islam, Globalization and The Search for Order and Justice," in http://www.politicsox.ac.uk/old/cis/seminars/Order-Justice-8.htm., accessed in 2000.

[22]Azyumardi Azra, "Challenge of Political Islam to Megawati," in *The Jakarta Post*, 21-22 November 2001.

[23]"The Other Side of Globalization, interview with Professor Paul M. Lubeck. In www.southreview.com., accessed on 5 October 2001.

[24]Robert J. Holton, *Globalization and the Nation State* (London: MacMillan, 1998), 48.

Meanwhile, the revival of political Islam can also be seen as a unifying factor and a focal point for the rallying political resistance against the international system and the State itself in the era of globalization. Hence, the globalization of Islamic revival can be interpreted as part of domestic as well as trans-national and international process.[25] It was basically a response to the global conspiracy against Islam or global hegemony of the Western world, particularly the U.S. Since the end of Second World War, the U.S. has been taking positions of dominance and hegemony in the Muslim world.[26] The West exercised its influences through a variety of financial and military means, a good deal of hegemony on the internal politics of Muslim countries, including support for regimes that are less supported by the majority of their own people.[27] The Islamic revival was also a refusal to the process of political and cultural homogenization of the Western world.[28]

The significant rise of political consciousness of Islamic organizations in many parts of both Muslim and non-Muslim countries, for example, is one of the crucial indicators of the Islamic revival in the last decade. This also may lead to the effort of the establishment of the "non-territorial Islamic state"[29] or the cross border flows of political Islam between (Muslim) groups/entities operating in different countries.[30] This phenomenon concurrently applies with the proposition of 'the hyperglobalist thesis' that new forms of religious (social) political organizations will supplant traditional nation-states as the primary political units of world society.[31]

While the level of public participation, particularly from the Muslim community, in the foreign policy formulation will be determined by the government's response to its domestic activities as well as its trans-national networks, the government's response itself depends on the government's political agenda of needs and the capabilities of domestic societies to involve in the foreign policy.

CONCLUSION

To sum up, the need to include non-governmental mechanism in the making of Indonesian foreign policy does not only reflect the changes of the government's paradigm in foreign policy, but also implies a significant response to the

[25]See, Ian Clark, "Beyond the Great Debate: Globalization and the theory of International Relations, in *Review of International Studies* 124, (1998): 479-498.

[26]Edward W. Said, "Islam Through Western Eyes." in Http://www.thanation.com, accessed in 6 November 2001.

[27]Shireen T. Hunter, *The Future of Islam and the West: Clash of Civilizations or Peaceful Coexistence?* (Washington: CSIS, 1998), 20.

[28]Robert J. Holton, *Globalization and the Nation State* (London: MacMillan, 1998), 175.

[29]Reuven Paz, Radical Islamist Terrorism: Points for pondering," in http://www.ict.org.il/articles, accessed on 15 October 2001.

[30]Michael Cox, Ken Booth, and Tim Dunn, *The Interregnum: Controversies in World Politics 1989-1999* (Cambridge: Cambridge University Press, 1999).

[31]David Held, Anthony McGrew, David Goldblatt, and Jonathan Perraton, *Global Transformations: Politics, Economics and Culture* (Stanford: Stanford University Press, 1999), 3.

rapid development in the domestic arena in which the societal factor plays crucial role in foreign policy making and to the challenges of the politics of globalization as well.

Furthermore, engaging greater public participation in the Indonesian foreign policy formulation will change the old paradigm in our foreign policy from 'the state leading society' in which a strong state guides an organic society toward adaptive foreign policy for the purpose of maintaining the power of the state to 'society leading the state' in which the society will have a larger role and access as well as higher level of participation in the foreign policy making. However, there are some other crucial aspects of this issue that need to be taken into account.

The Indonesian domestic political map has changed considerably in the period when the political awareness of the Muslim community and the number of Islamic political parties and groups have significantly increased in the late 1990s. In this context, the degree of "secularization of polity" and "religionalization of polity" concerning the relationship between the state and religious community at the national level will remain debatable in the making of Indonesian foreign policy in the post-Soeharto era.



INDONESIA & AUSTRALIA: BILATERAL RELATIONS INTO THE 21ST CENTURY

Jointly published by: Centre for Strategic and International Studies *(CSIS)*, Jakarta, and The Indonesia Project-The Australian National University (ANU), Canberra.

The bilateral relationship between Indonesia and Australia has long been taking place in various areas. However, over five and a half decades, this relationship had its ups and downs. What both countries can do is to co-manage their relationship with sobriety, good sense as well as good will so that mutual trust can be maintained and each country can figure positively and strongly in the security and prosperity of the other.

In an attempt to maintain and strengthen various channels of communication between Indonesia and Australia, CSIS in cooperation with the Indonesian Project at the ANU held a conference on "Indonesia-Australia Bilateral Relations" in March 2001. During the conference various issues were raised and discussed. The discussion was mainly focused on the recent developments in the two countries and how these might affect the relationship. They are then summarized in this publication.

The summary of the discussions is organized into two broad topics: (1) Bilateral Relations into the 21st Century; and (2) Indonesian Perspectives on the Bilateral Relationship. They include issues among others on Economic Developments in Indonesia; Developments in Australia; Trade Relations between Indonesia and Australia; and, Future Relations between the Two Countries. This book will, therefore, contribute some knowledge to those who are interested in the study of international relations, particularly in the bilateral relationships between Indonesia and Australia.

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Effects of the Increasing Regionalization on the Internationally Diversified European Companies

Heike Proff

INTRODUCTION

WITH the increasing regionalization (especially with the creation of NAFTA, MERCOSUR and AFTA) and the growing economic importance of these new regional integrations, the environment of European companies has been changing at both the business unit level and the corporate level. This, in turn, has affected diversified enterprises, which are mostly active on the international scale. With regard to these enterprises, the following questions should therefore be examined:

- Which opportunities result from intensified activities in one or several countries of the new economic regions?
- To what extent are the companies forced by the increasing international competitive pressure to exploit these opportunities?

The study is focused on the opportunities offered by the regionalization as well as on the problems resulting from the increasing regionalization that affect the European companies as the third-country enterprises located in the new integrated areas.

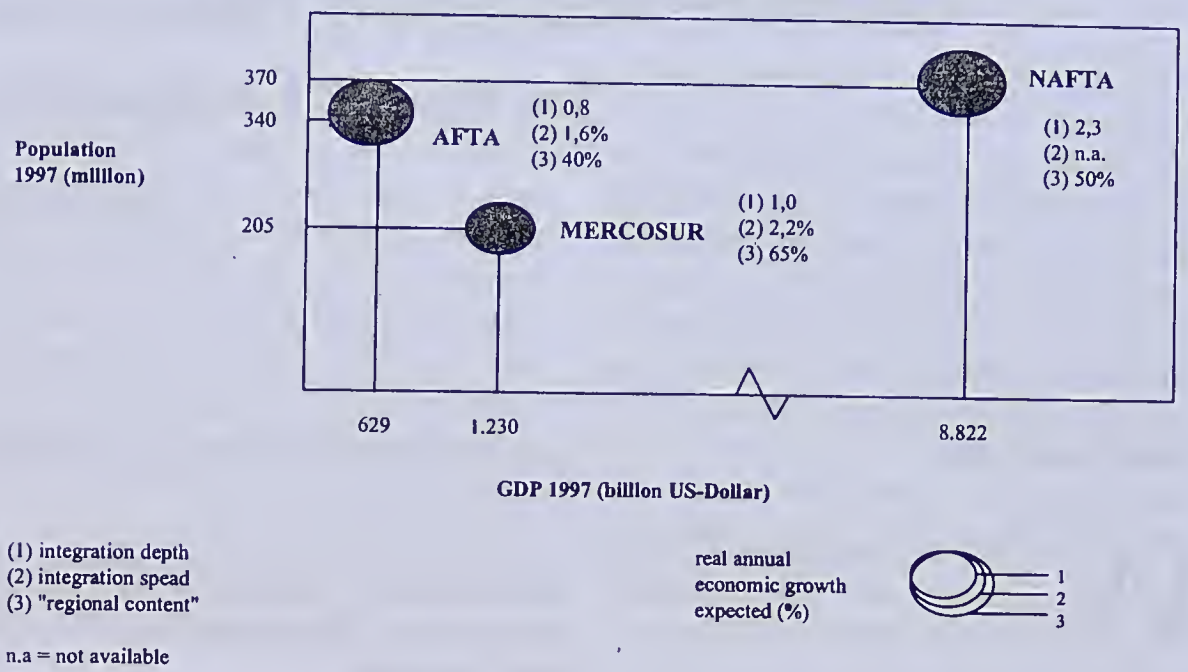
ECONOMIC SIGNIFICANCE OF REGIONAL INTEGRATIONS OUTSIDE EUROPE

To be able to assess the changes in the international business environment resulting from the growing global trend towards regionalization, it is necessary to observe the market potential and dynamics of the currently most significant regional integrations outside of Europe as presented in Figure 1. The gross domestic product (GDP) represents one factor indicating market potential (purchasing power in the individual domestic markets related to the population). The size of the circles corresponds to the real annual economic growth expected in the three regions in the medium term (AFTA 4,1%; NAFTA 2,4%; MERCOSUR 1,8%) and is an indicator of the market dynamics.

The depth and speed of the integration indicate the degree to which the integration efforts have advanced and how rapidly they

Figure 1

THE ECONOMIC SIGNIFICANCE OF NAFTA, MERCOSUR AND AFTA



Source: Own compilation based on the data taken from International Bank for Reconstruction and Development, 200-201.

will develop in the future. With their help it is possible to estimate the point in time when third countries will be able to exploit the expected market potential and when the predicted growth will actually have been achieved.

According to Hufbauer and Schott (1994, 3.13), an integration process comprises six elements leading to an increasing integration depth, namely free movement in goods and services, free movement of capital, free movement of labor, supraregional institutions, monetary co-ordination and fiscal co-ordination. With these elements, the current integration processes can be illustrated much better than with the formal textbook diffentiation between the various forms of regional integration (free-trade zone, customs union, common market, economic union and political union). For example, in addition to the liberalization of trade, NAFTA as a free-trade zone is focused on a free movement of capital, while a free movement of labor is largely excluded. Hufbauer and Schott (1994) evaluate the integration depth achieved so far in the regions of South and North America on the basis of extensive macroanalyses, using a six-step scale ranking from 0 (low) to 5 (high). It becomes evident in this process that NAFTA has reached the highest integration depth (with an average evaluation of 2.3). In contrast, the regional integration of the MERCOSUR and AFTA countries has not progressed as far (1.0 and 0.8 respect-

ively). The differences are mainly in the removal achieved so far of the restrictions for movement of goods and services as well as for the movement of capital. The European Union has clearly made more progress. In comparison, the union's integration depth is evaluated at an average of 3.3, mainly because of the supranational institutions but also because of the relatively high degree of implementation regarding the remaining elements of the integration process, with the exception of fiscal coordination.

Regarding long-term decisions of enterprises, the further development up to the full realization of the regional integration is of interest as well. One indicator of this development is the speed of trade integrations - the difference between the average annual trade growth and the average annual growth in the production volume (output) in a region. Although the World Bank's prognosis of the speed of the integrations in South America, Southeast Asia and sub-Saharan Africa for the period from 1997 to 2004 (World Bank 1995) refers to larger areas and not to regional integration efforts, it still shows a generally higher integration speed in South America (2.2%) than in Southeast Asia (1.6%) and sub-Saharan Africa (0.4%). This points to a more pronounced region-internal interlinking of the individual markets and makes the integrations in these regions appear more permanently.

However, companies from other economic regions (third-country enterprises) will have to adjust the economic significance of an integration to reflect the "regional-content" requirements which indicate the extent to which the local value added is to be reached when goods are to be imported profitably in spite of customs charges. In the NAFTA negotiations, a regional content of 50% was agreed, while AFTA requires 40% until the year 2003, and MERCOSUR 65%. These targets must be analyzed very carefully as various reference figures are possible for the required regional content (product costs, total production costs or even the weight of the goods). Moreover, special regulations are often created for sensitive areas, and these regulations are sometimes very restrictive with regard to third-country enterprises. Sometimes, liberalizations in individual sectors apply only to enterprises form the partner countries, even though the WTO is trying to eliminate this policy. In general, however, final assembly businesses with a very low value added in the new integration areas do not seem profitable for third-country enterprises.

The following study of the effects of increasing regionalization outside of Europe does not distinguish between regions of different integration depth and speed. However, it is implicitly assumed that the more pronounced the effects derived from integration are, the higher the market potential and dynamics as well as realization and permanency (i.e., depth and speed) of the regional integrations will be.

CHANGES IN THE IMMEDIATE AND BROAD ENVIRONMENT OF THIRD-COUNTRY ENTERPRISES

Although customs duties will frequently be abolished completely only after very

long transition periods (for example, in NAFTA as late as in 2009), politically and economically more stable environmental conditions are created already at the time the decision to form a regional union is made - a direct effect of regionalization which is significant also for enterprises from third countries which are no members of these unions. This aspect is particularly important for these enterprises' involvement in less developed countries because higher allowances for risks must be made in a politically and economically instable environment, thereby rendering many investments unprofitable. Consequently, regional unions formed by so far less developed partner countries are considered, in the long term, particularly attractive fields of operations for multi-national companies.

The direct effects of regional integrations are as numerous as the integrations themselves (Proff 1994). Even though the connections established in the theory of international trade do not differentiate between the effects of increasing regionalization on various company levels, different effect connections are placed at the center of interest according to the differentiation between a broad company environment (primarily the fundamental political and economic conditions) and an immediate company environment (the sales, procurement, money, capital and labor markets). With regard to the effects of increasing regionalization on the broad company environment of third-country enterprises, this paper focuses less on the changes in the fundamental ecological, technological or sociocultural conditions but rather on the political and economic effects.

Political Effects

Among the political effects that are expected to evolve from a regional integration is the development in the partner countries of a democracy which is able to function, and of a more pronounced orientation towards market principles. Moreover, political risks such as revolutions and wars will probably diminish (Vernon-Wortzel and Wortzel 1990, 135), as each partner country takes on the obligation to ensure a higher political stability. Consequently, the country-related risk as a factor influencing corporate decisions decreases.

Economic Effects

Among the economic effects of a regional integration, a differentiation between two types can be made, namely (1) effects within the partner countries, and (2) changes in the relations between the partner countries. According to the static theory of international trade, each partner country is expected, with increasing integration depth, to intensify the fight against inflation and budget deficits, i.e., to strive for economic stabilization. This also leads to lower risks, such as the danger of nationalization and expropriation or indirect discrimination against foreign enterprises, for example in the awarding of government contracts. This process does not only explain the attractiveness of such countries as production locations for third-country-enterprises. In addition, the country-related risk as a factor influencing corporate decisions decreases even more as a result of the fundamental economic conditions which can now be calculated much easier. Re-

garding the economic effects on the relations between the partner countries of the integration area, a differentiation is made again, according to the theory of international trade, between (a) monetary and (b) non-monetary effects.

- ***Monetary Effects***

 The main monetary effects in this case include, above all, the creation of large currency areas as a result of regionalization, and the limitation of national solo runs in the field of currency policy. The calculation of third-country enterprises is thus facilitated, and the currency risk is considerably reduced, especially because the new integration areas are oriented either towards US$ or Yen. Moreover, the decrease in exchange rate fluctuations or in the restrictions of capital movements leads to a reduction of trancaction risks, i.e., risks concerning the transactions carried out between countries, which in turn is significant from a corporate point of view.

- ***Non-monetary Effects***

 The non-monetary economic effects of a regional integration include primarily a further decrease in the transaction risks as a result of the abolition of tariffs and other non-tariff barriers to trade. In addition, it is possible to deduct - with the help of the static theory of international trade which compares two equilibrium points, one with and one without tariffs- trade-creating effects within a region and trade-diverting effects with regard to third countries both for inter-industrial trade, i.e., trade with goods at different production stages, and for intra-industrial trade with products at the same production stage. Thus large internal markets are created where not only the sales, procurement and investment conditions of the business units are improved. Concerning the third-country enterprises, the sales conditions are better only if production takes place within the region where resources and special competences can be employed or developed more efficiently - an aspect that is particularly important from a corporate point of view. The increasing convergence of the economic course in the partner countries of the regional integration will probably reduce the uncertainty about the economic development even more.

Due to the decrease in the country-related risks, the reduction of transaction risks and the development of larger internal markets as a result of increasing regionalization, the immediate company environment of third-country enterprises has changed as well, namely on the sales, procurement, money and capital as well as labor markets.

The most important change is the improvement of the *sales conditions*. The tight domestic markets in the individual partner countries of a regional integration frequently precluded a more active involvement of third-country enterprises, because exports were often impeded by import restrictions and the necessary investments were not profitable for a company. In addition to

leading to larger internal markets, regional integrations also result in stronger economic growth in the participating countries, the sales potential is accordingly increasing as well. In order to be able to make a more precise estimate of the sales potential, it is necessary to establish, through empirically based hypotheses, a connection between economic growth -induced by the regionalization- and the sales of specific goods. With regard to less developed countries, for both disposable and durable consumer goods, a correlation is frequently established between the development in the sales of a specific good in higher developed countries and the per-capita income (Karamokolias 1990, 3). Equally important is a detailed analysis of the income distribution, which indicates the expected additional demand for specific goods depending on the development of the economic situation, and with consequently supplies information that is important for the decision of third-country enterprises on direct investment.

Regional integration also improves the *procurement conditions* for the business units to third-country enterprises being active in the integration area, because the offered range of processed raw materials and intermediate products is expanded, and particularly foreign enterprises can at the same time increase the pressure on domestic suppliers with regard to supply and investment in these markets. Domestic suppliers in turn will be able to give in to this pressure more easily, because the overall sales conditions will improve for them, too, in the united markets, and empirical studies, such as one conducted by Kuhlmann (1992), show that the sales potential is the location factor that is the most important for the supply industry.

As a result of a regional integration, the *investment conditions* will also improve, initially only for enterprises of the partner countries, since their governments want to grant advantages primarily to domestic companies. This becomes evident, above all, by the requirements regarding regional value added for third-country enterprises (regional content) as a prerequisite for the duty-free sale in the partner countries, and by regulations on foreign currency compensation.

STRENGTHENING OF COMPETITIVE ADVANTAGES BY THE CHANGES IN THE ENVIRONMENT: OPPORTUNITIES PROVIDED BY REGIONALIZATION

The occuring changes in the company environment will directy affect competition. Indirectly, the increasing regionalization thus opens up opportunities for European companies which are diversified outside of Europe. Even though competition takes place between product-market areas and consequently, between business units, competitive advantages only on the level of business units are insufficient. In view of the increasing competition of diversified companies involving several business units (multiple-point competition) (Porter 1985, ch. 9), competitive advantages are necessary also at the corporate level for several business units. Consequently, a differentiation is made between (1) low costs and uniqueness from the customer's per-

spective, or globalization and adaption to country-specific requirements as competitive advantages in business units, and (2) decreasing risk and higher returns as the advantages in the multiple-point competition.

This paper is designed to show that regionalization enhances these advantages for European third-country enterprises. Unlike in the pprevious section, the level of business units will be discussed first, because the obtaining of advantages in the multiple-point competition complements the competitive advantages in the business units.

Improved Dissociation of Costs and Benefit Increases Along The Value Chain

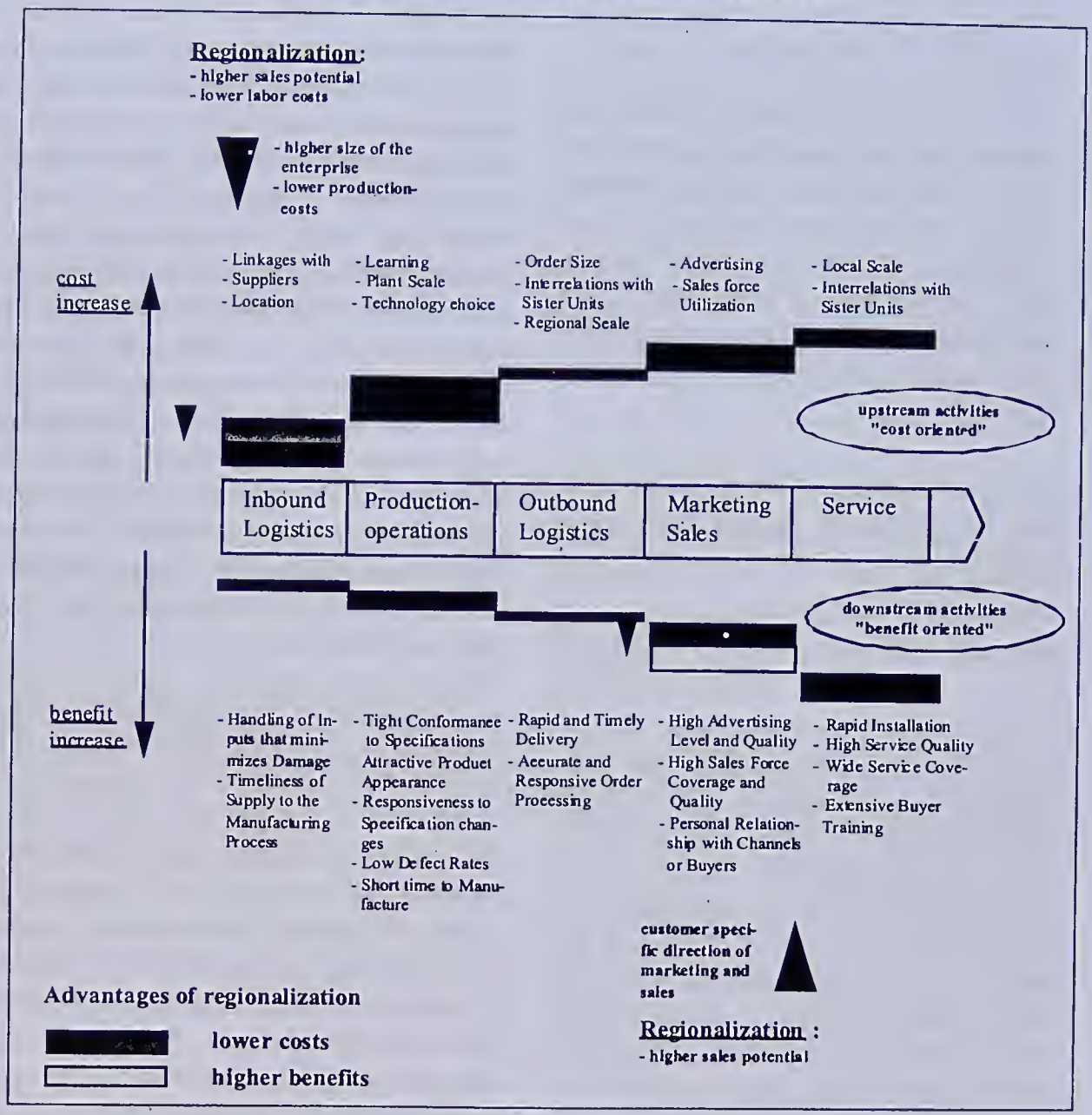
Any study of the business unit level should at first refer to Porter's strategic concepts. According to his theses of "stuck in the middle", business units can be successful only either with low costs (e.g., globalization advantages) or with differentiation (advantages resulting from an adaption to country-specific requirements), but not by combining the two advantage categories (Porter 1980, 73). According to the more recent strategic literature, however, this combination seems possible by dissociating the costs and benefit increases along the value chain (Proff 1996).

The effects of changes in the environment in general and, more specifically, those of increasing regionalization on the level of business units involve both competitive advantages (cost reduction and rise of benefits) and have an impact on the possibilities for a dissociation of the cost and benefit increases along the value chain. The value chain can be divided into upstream (buyer distant and cost oriented) and downstream (buyer tied or benefit oriented) activities. A strategic dissociation of the cost and benefit increases along the value chain is possible to the extent that customers attach more importance to individual elements in the value chain than to others. This leads to a higher increase in benefits, but not to a parallel higher increase in costs. With this approach, the traditional paradigm of production management on which Porter's concept is based and which stipulates that quality has a cost equivalent and that only either cost advantages or differentiation (through superiour quality) can be achieved, can be overcome for many products. These dissociated cost and benefit increases along the value chain are shown in Figure 2.

While the greatest cost increase usually occurs in the field of manufacturing operations, the highest benefit increase can be obtained in the fields of marketing and distribution as well as in the customer service field. Initially, the possibility for a dissociation along the value chain is not tied to international activities. In general, it is possible for each business unit to study and differentiate those elements in the value chain leading to different cost and benefit increases. However, the relevant environment has an impact on the possibilities for dissociation, and in this context, an international area of activity offers the opportunity for the business units to relocate individual elements of the value chain to countries with comparative advantages.

Figure 2

DISSOCIATION OF THE COST AND BENEFIT INCREASE ALONG THE VALUE CHAIN AND THEIR IMPROVEMENT BY REGIONALIZATION



Source: Own compilation based on Carl (1989, 159) and Porter (1985).

Figure 2 shows possible starting points for improving the possibility for a dissociation of cost and benefit increase along the value chain on the basis of the trend towards regionalization also for production activities from third countries and, thusfor European companies. *First*, manufacturing operations involve cost structures that are dependent upon batch sizes; and marketing/distribution as well as customer service

can be expected in a demand-oriented manner only given a product-specific minimum volume. It was already stated that the expansion of the sales market as a result of the combination of small individual markets to form one large internal market and the resulting higher economic growth constitutes -from the entrepreneurial perspective- an essential result of regionalization. *Second*, less developed countries are currently unifying to form regional integrations in MERCOSUR and AFTA, but also in NAFTA with Mexico. With the expansion of the sales market, they enjoy the advantage of lower labor costs in (some) partner countries in the integration area.

As indicated in Figure 2, the increase in the sales potential as a result of regionalization promotes both a reduction of costs in manufacturing operations in view of the possibility of expanding the size of the enterprise, and an increase in benefits in the fields of marketing/distribution and customer service by providing the opportunity to coordinate, on a region-specific basis, sales promotion, distribution networks and customer services. By utilizing comparative labor cost advantages in individual (less developed) partner countries, manufacturing costs can be further reduced. Production in the region, which is necessary to avoid high external tariffs, thus becomes also profitable for business units in European companies.

Additional Potentials for Reduction of Risks and Increase in Returns

At the corporate level, the effects of changes in the environment and, thus, country-specific and transaction risks as well as the expansion of foreign markets due to the increasing regionalization are important for the advantages in multiple-point competition. *First*, reduction of the (company-) specific or unsystematic risk, resulting from uncertainties, such as a slump in demand, scarcity of ressources, lack of labor or management mistakes, by diversifying not only into several business units (Markowitz 1992), but also into several markets. *Second*, long-term increase in returns through improved possibilities for the additional utilization of existing synergies or the obtaining of new synergies, as well as of additional new competences (Porter 1987, or Hamel and Prahalad 1994).

Reduction of The (Company-) Specific or Unsystematic Risk

The majority of considerations regarding the potential for risk reduction of an international diversification refer to the market risk and can be transferred to activities in different integration areas. According to this approach, it is possible for a company to balance political, economic and social country-specific risks by being active in an ever increasing number of markets (Bühner 1993, 342). In a verification of Markowitz portfolio theory, Grubel (1968) showed that it is possible for the individual investor to diminish the market risk by a portfolio of international securities. Other studies show that the market risk can be reduced by diversification abroad and improved similar to risk-return approach of the shareholders, because the national economic and sector-specific cycles develop differently in the individual

countries. When this approach is transferred to international diversification, an additional potential for risk reduction will probably be obtained as compared to national diversification (Lessard 1995, 18). The potential for a (market) risk reduction in international activities will presumably not be dependent only on the number of business units abroad, but will be influenced by three additional factors, i.e., the scope of the activities abroad, the extent of the transaction risks, and their distribution across different markets.

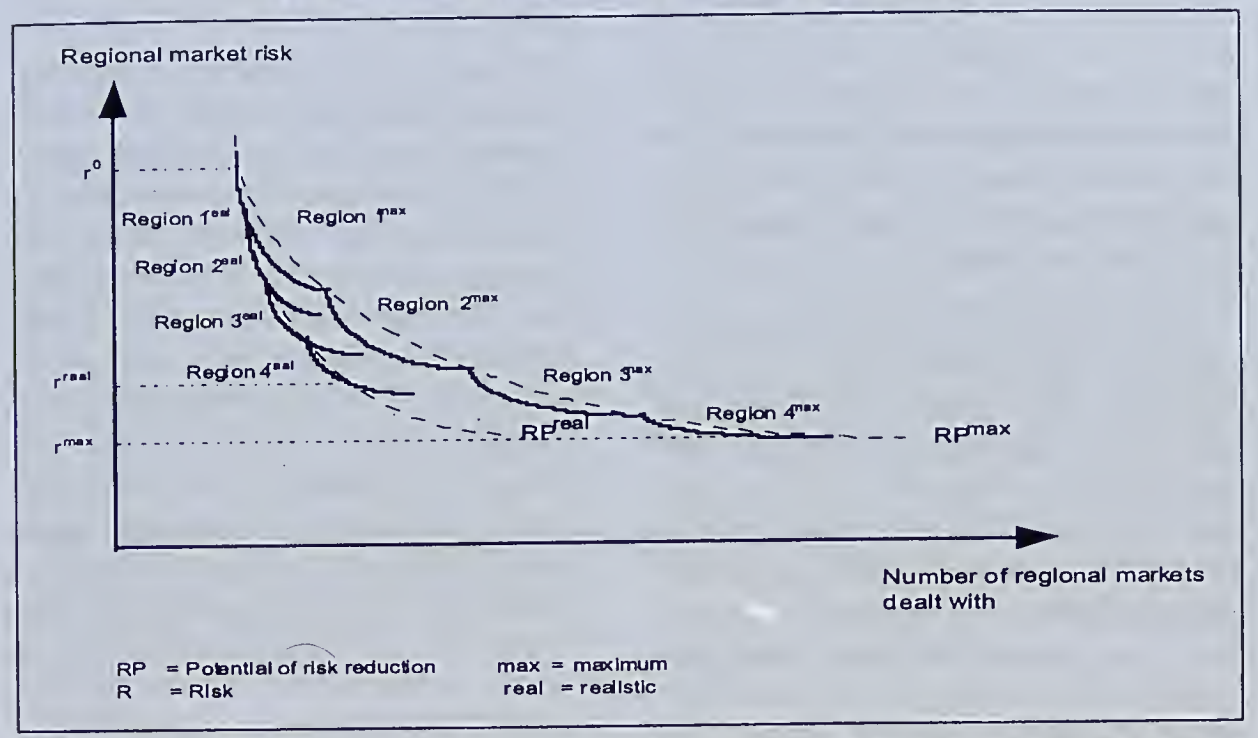
In this context, a balanced distribution of the activities across different country markets, as it is implicitly assumed in the portfolio theory, is of particular importance. It is an assumption which, due to the increasing regionalization in the global economy, is becoming more and more probable because the economic differences between regional internal markets will be less pronounced than between individual country markets. As a result of the increasing trend towards regionalization in the global economy, new opportunities are created even for those (third-country) enterprises which have already been very active over a long period in a few or many regionally concentrated, stable country markets with a high market volume, market share and market potential (for example, in different European countries), and which seem to have exhausted, as much as possible, the possibilities for risk reduction.

In view of the convergence of the development of the economic situation in the partner countries of the integration areas, there is not only the opportunity for balanced activities in several integration areas but, at the same time, the pressure to achieve the highest possible value added in each of the regional markets, as the potential for a reduction of the country market-specific risk is limited and the potential for a reduction of the regional market risk must thus be exhausted as much as possible. Due to the closely linked development of the national economies of the partner countries, the (regional) market risk can be reduced by activities in many country markets within one region only to a lesser extent than by activities in the same number of countries in different regions, as indicated in Figure 3.

Figure 3 shows the potential for the (regional) market risk reduction of an internationally diversified company that can be obtained by activities in four integration areas. In the case that a company is equally active in all four country markets, a maximum potential for (regional) market risk reduction (Rp^{max}) can be calculated by adding the four potentials for risk reduction (decrease of the regional market risk from r^0 to r^{max}). As this hypothesis is not very probable even for a financially strong and internationally diversified company with high sales volume, it seems more realistic that the company becomes active in selected country markets (i.e. those with highest possible value added) of every region (realistic potential for the reduction of the regional market risk RPreal by a decrease of the potential for risk reduction from r^0 to r^{real}). An even distribution of activities abroad with a strong value added across the indivdual integration areas becomes possible at all only because of the expansion of internal markets as a result of regionalization.

Figure 3

MAXIMUM AND REALISTIC POTENTIAL FOR (REGIONAL) MARKET RISK REDUCTION BY ACTIVITIES IN DIFFERENT INTEGRATION AREAS



(1) For simplification purposes, it is assumed that each integration area has the same potential for risk reduction. Consequently, for four companies in one integration area each, the four curves illustrating the potential for (regional) market risk reduction would be identical. If, however, one company diversifies its activities across the four integration areas, the potential for the reduction of the (regional) market risk will decrease, in accordance with the assumption of the portfolio theory, assymtotically with each additional regional market.

Source: Own compilation based on Carl (1989, 159) and Porter (1985).

Potential for an Increase in Returns of European Companies

The potential for an increase in returns of European companies as a third-country enterprises are enhanced in an environment characterized by increasing regionalization and larger internal markets, given the improved possibilities for utilizing and obtaining synergies and competences.

An *improved utilization of synergies* is possible in particular when a diversified third-country company has been active in one partner country even prior to the integration. Activities abroad can be compared with a sequential process which runs faster and involves less costs the better the knowledge of the market is (Kogut 1985). When the economic, political and socio-cultural conditions are harmonized in the partner countries within the integration area, the expertise and experience (know-how) gained in one of these countries can be used in order to enhance the activities in this region. Investments that

have already been made here and sinking fixed costs create additional opportunities for realizing profits and new possibilities for additional activities. With regard to (third country) companies, which have not been active in one of the partner countries prior to the integration, the pressure increases to invest here in order to launch the sequential process of activities abroad and to exploit synergies in the region.

The prerequisites for *obtaining new synergies* as a result of the increasing regionalization are that a (third-country) company has sufficient ressources at its disposal and that the local environment is of great strategic significance (Bartlett and Ghoshal 1989). The increase in returns that can be realized by activities in a regional integration due to the improved utilization of existing synergies can be employed to increase the company´s resource base. In addition, the strategic significance of a regional environment is greater than that of a local environment. As a consequence, it can be profitable either to centralize activities that have been conducted globally on a decentralized basis, or to compile and combine the new know how from various areas.

As a result of the improved possibility for an enhanced or additional utilization of core competence at the corporate level due to regionalization, potentials for increasing returns will probably be created in addition to the obtaining of synergies. This is true also for third-country companies, as long as they have special resources or competences at their disposal or/and can establish them in the foreign market. From them, potentials can be created by

- an enhanced utilization of already existing competences, i.e., unique capabilities, within a portfolio of business units, which corresponds to the "fill in the blancs" pursuant to Hamel and Prahalad (1994, 227);
- an additional utilization of existing core competences. Frequently, this is possible only when the integration depth in the internal markets, which have expanded due to a trade integration, increases - an assumption that can actually be made regarding NAFTA, MERCOSUR and, with a delay, AFTA as well, from the point of view of internationally diversified European companies;
- obtaining of entirely, or at least partly, new competences or "mega opportunities" (Ibid, 230). It is easier to obtain competences in an integration area, because the strategic importance of a market increases with its size (Bartlett and Ghoshal 1989), and the centralization of tasks or functions for the global market is of advantage even within a region. Thus, the strong position of a (third country) company in those markets where it has been active so far can be protected; and preventive measures can be taken against the danger that already existing competences might deteriorate into basic capabilities. New competences can replace existing competences in order to ensure that consumer demands can be satisfied also in the future.

INCREASE IN THE INTERNATIONAL COMPETITIVE PRESSURE BY CHANGES IN THE ENVIRONMENT: CONSTRAINTS RESULTING FROM REGIONALIZATION

The strenghening of competitive advantages by increasing regionalization

applies not only to European third-country companies but also to rivals from other third countries and, above all, from the integration area itself. As a consequence, competition within the new integration areas becomes more fierce. This process can be illustrated using a notion similar to the one employed by Perlitz (1995, 2), which may be called "international chase line". In this notion, companies from developing countries, e.g., from the special trade zone of Shenzhen in China, are "chasing" companies form newly industrial countries, which in turn are chasing Japanese, North American and European companies. Western companies in general and, more specifically, European enterprises can respond to this competitive pressure only with active strategies.

The pressure towards more innovative entrepreneurial activites as a result of increasing regionalization is reflected also by the more dynamic theses of the new theory of international trade. In this context, the effects of a regional integration on the production capacity and the output of individual business units of a diversified (third country) company can be studied. This approach facilitates a microeconomic analysis of dynamic market-related and competitive processes. With the help of this analysis, strategic pathways towards a parallel realization of country -and company- specific advantages can be deducted for four company types, i.e., in our case, business units (innovative, spontaneously imitating, responding and immobile business units). (For detailed deduction of strategic pathways using a dynamic approach, see Poff, H.V., 1994, 54-62).

Strategic Reactions to Increasing Regionalization

Changes in the environment affect different points in the strategic system of a diversified company. This system is based on a hierarchical two-level model, as well as on various degrees of complexity and on the significance of the strategies for the continued existence of the company. According to the organizational area in which a (competitive) strategy is valid, the system distinguishes between the following strategies: (1) Strategies on the level of the entire company (corporate or company-wide strategy); and, (2) Strategies on the level of the individuel business units, such as business, business unit or competitive strategies (Porter 1987, 43).

While companywide strategies determine the nature and number of the business fields in which activities are to be performed, as well as the focal points for the allocation of financial resources to the business units and, thus, define the long-term objectives of a company as well as the policy guidelines, the ways and means to obtain these objectives, business unit strategies are directed towards the product-market situation or the competitive position of an individual strategic business unit of a company (Macharzina 1995, 230). Moreover, a third strategic level is often introduced, namely functional area or operational strategies, including, inter alia, marketing, personnel and manufacturing strategies (Hofer and Schendel 1978, 27-29). In the context of this paper, it seems appropriate to exclude this strategic level, as the strategies yield competitive ad-

vantages only for individual elements of the value chain and therefore do not represent corporate strategies within the framework of a management approach going beyond functional areas.

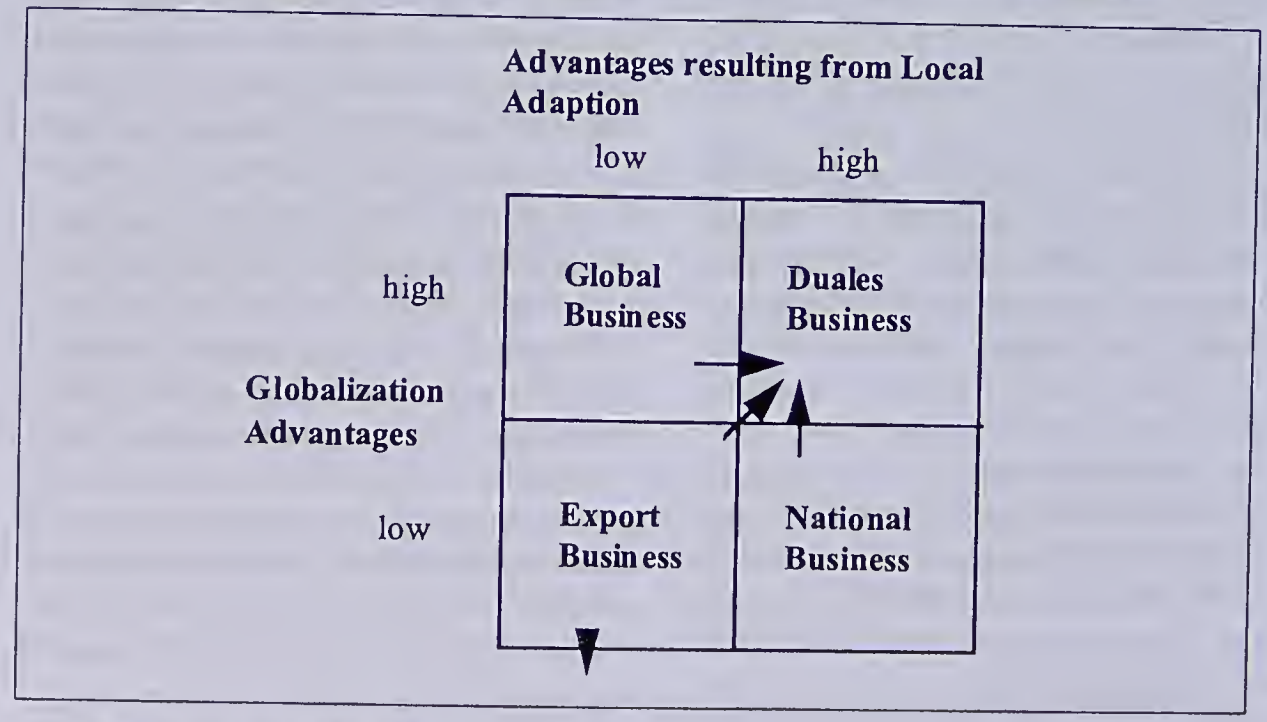
Which strategic reactions of internationally diversified European companies are, then, rendered possible and, at the same time, indispensable by increasing regionalization outside of Europe?

Business Units Turn To "Dual Business"

In addition to Porter´s (1980, 39) generic strategies of comprehensive cost leadership and differentiation regarding the activities in both the entire market and individual submarkets, which are based on a separation of the competitive advantages, the more recent strategic literature has introduced "hybrid strategies" (Proff 1996) combining the two competitive advantages by dissociating cost and benefit increases along the value chain (see Figure 2) into the discussion of strategies at the business unit level. In Greek hybrid means "to be composed of various things" or "to be developed from cross-breedings". The optimization of worldwide activities within the value chain improves the possibility of hybrid strategies to the extent that worldwide trends towards regionalization improve the possibilities for a dissociation of cost and benefit increases along the value chain.

Figure 4

STRATEGIC ALTERNATIVES FOR ACTION IN INTERNATIONAL MANAGEMENT AND POSSIBLE CHANGES FROM WORLDWIDE TRENDS REGIONALIZATION



Source: Based on Carl (1989: 198).

The decision on the elements of the value chain in which a producer will invest will be based on an analysis of the *competitive advantages*, while the decision on where these activities will then be conducted will be made based on an analysis of *comparative advantages*. With the help of a value chain, Carl (1989, ch. 3) develops a set of references to record the strategic options for the business units of an internationally active company. If the aim is cost leadership, the cost-creating factors must be known, as well as the possibilities for obtaining "globalization advantages" by exploiting scale effects. If such a strategy is not possible because of differences in legal requirements or/and customer demand, then those activities are significant which contribute to the development of an unique selling position and to the "advantages resulting from local adaption". Figure 4 presents four strategic alternatives in international management, using the benefits and cost dimensions of "advantages resulting from local adaption" and "globalization advantages":

- "export business", involving little globalization and local adaption;
- "global business", involving large globalization advantages obtained by "economies of scale" (cost orientation by standardization and process innovation) and little local adaption;
- "national business", involving large advantages of local adaption obtained by product and strategic innovations; and
- "dual business", involving globalization and local adaption advantages ("economies of scope" resulting from a "mix of strategies" including cost orientation and process innovation as well as product and strategic innovations).

As shown in Figure 2, regionalization positively affects both the globalization advantages and the advantages resulting from local adaption, due to a significant increase in market size as well as to an intra-regional harmonization of the legal requirements and/or the customer needs. Therefore it creates the preconditions for a superiour business unit strategy, i.e. the realization of "economies of scope" in a framework of "dual business" (based on hybrid strategies). As a consequence, the establishment of regional integrations leads to a shift in international competitive strategies from the one-sided orientation towards either "globalization advantages" or "advantages resulting from local adaption" to the simultaneous realization of both types of advantages. Due to regionalization, the "export business" will be even less attractive for third-country enterprises, because exports do not meet the necessary "regional content" requirements so that the related competitive advantages can be exploited only to a limited extent. This illustrates that it is particularly important for export-intensive European companies to devise strategic reactions.

CORPORATE UTILIZATION OF THE EXISTING AND ADDITIONAL SYNERGIES AND COMPETENCES IN THE NEW INTEGRATION AREAS

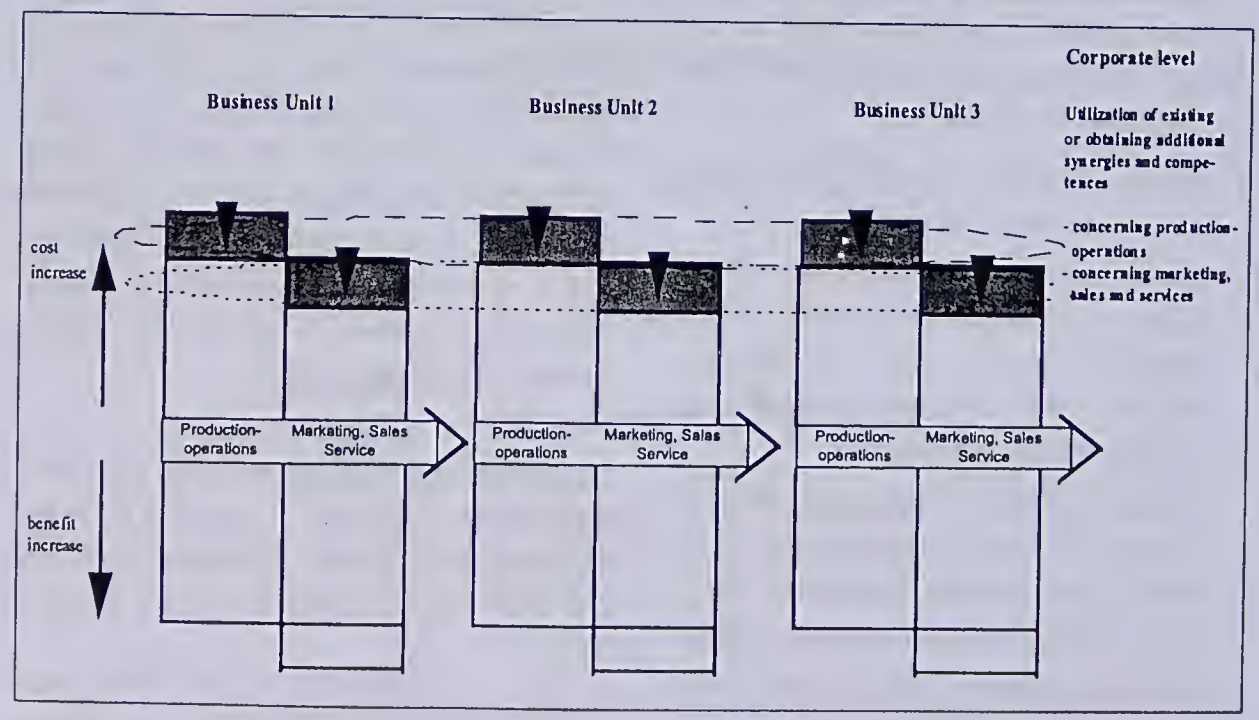
The enhancement of the advantages in multiple-point competition by increas-

ing regionalization (additional potentials for risk reduction and/or increases in returns) also provides an impetus, as well as pressure, to consistently implement a corporate strategy for European companies as well.

At the level of companywide strategies, there are three "basic categories of corporate alternatives" (Rue and Holland 1989, 40): growth, stabilization and shrinking strategies. These can in turn be devided into various "generic corporate strategy alternatives" (Ibid.) which determine the manner in which the activities in the individual business units are coordinated. These variants of the basic categories represent companywide strategies in the strict sense. It is, however, not necessary in this context to take a closer look at variants of the stabilization and shrinking strategies, because these are generally neither of a strategic nature -i.e., they are not selected in the course of a conscious decision-making process- nor long term. With regard to variants of the growth strategy, six companywide strategies can be listed in historical order (Goold, *et.al.* 1994, ch. 2): (1) non-related diversification; (2) related diversification; (3) vertical diversification; (4) concentration on core business activities as "product-market strategies"; (5) concentration on core competences; and, (6) diversification around core competences as "strategies of potential" - although the latter do not represent proper strategic alternat-

Figure 5

ENHANCED COMPETITIVE ADVANTAGES OF INDIVIDUAL BUSINESS UNITS DUE TO MULTIPLE-POINT COMPETITION AS A RESULT OF INCREASING REGIONALIZATION



Source: Own compilation.

ives but rather, given the increasing international competitive pressure, a necessary additional measure to increase returns.

The most significant reduction of the market risk will probably be achieved through a risk-oriented international diversification which complements a non-related diversification, because that is this strategy´s primary aim in order to be able to exploit the potentials for the (regional) market risk reduction shown in Figure 3. In addition, the market risk can also diminish as a result of synergy-oriented and competence -based corporate strategies- even if this is not the declared objective - when a company has not yet been active previously in many stable markets with high market volume, market share and market potential.

Long-term potentials for increases in returns may be realized to a higher degree in an integration area than when the company is restricted to the home market or active in regionally not integrated markets, by intensified or additional utilization of existing, or the obtaining of new, synergies and competences. By employing such diversification and concentration strategies, the dissociation along the value chain and the pursuit of hybrid strategies in the business units can be complemented by the circumstance in which the increase in costs is reduced, relative to the increase in benefits, as a result of lower risks and higher returns (see Figure 5).

It is thus possible for business units of European companies to more effectively dissociate the cost and benefit increases along the value chain by exploiting region-specific advantages, so that they can, for example, reduce costs in the manufacturing sector by using the same parts and by producing in a country with comparative advantages, without running the risk of a loss of benefits regarding customers. Moreover, by combining the value activities of several business units in one region, they can realize additional cost reductions through synergies and competences. It must be considered, however, that internationally diversified European companies require a high extend of information, planning, decision-making and control, which may result in high complexity costs that could overcompensate the long-term potentials for increases in returns achieved through additional synergies and competences.

According to Bartlett and Ghoshal (1989), companies therefore have to complement strategies for obtaining competitive advantages by employing skillful labor force, shaping interdependencies within the company, and creating a regional network. In doing so, the coordination and transaction costs may not rise to the extent that they outweight the regional potentials for increasing returns through exploiting synergies and competences. Due to the geographic vicinity of the partner countries, not only ransportation routes become considerably shorter than the distances between global regions, but also the countries economic, political and social-cultural similarities facilitate the utilization and obtaining of synergies and core competences to a much higher degree than this is the case for global activities. However, the regional structures should not become too isolated.

A CONCLUDING NOTE

It becomes evident in the economic and management analysis of increasing regionalization that even internationally diversified European companies can profit from intensified activities and a higher value added in the new integration areas. In view of the rising international competitive pressure, European companies have to react (1) to the improved sales, procurement and investment conditions at the business unit level, with the "dual business" and (2) to the enhanced potentials for risk reduction and increase in returns at the corporate level, with region-specific concentration or diversification strategies.

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